Examiner's report

F7 Financial Reporting
December 2009

General Comments

The overall performance of candidates in this diet was much improved on the poor performance in June 2009; however there is still considerable room for improvement. The main drawback to candidate's performance is once again a lack of syllabus coverage. This is evidenced by many scripts only answering four, or sometimes only three, of the compulsory five questions. It is also the case that even where five questions had been attempted the answers to the non-core questions (four and five) were usually worse than those of the three more expected questions.

Feedback from the Examination Review Board, tutors and markers was favourable believing this to be a fair paper, challenging in some areas, with good syllabus coverage. A well-prepared and question-practiced candidate should have had no real difficulty in obtaining a pass mark. There was some evidence from candidates of 'running out of time', however this seemed due more to poor answer planning and time wasteful examination techniques (unnecessary and over elaborate workings, repetition of points etc). There were a significant number of scripts where candidates had crossed out the first page (sometimes more) of their answers; this demonstrates poor answer planning and a consequent inevitable waste of valuable time.

The report's function is to give a critical review of candidates' performance focussing on common errors made. This is intended to be of beneficial use to candidates attempting the paper in the near future such that they may avoid the pitfalls of poor examination technique and errors made by previous candidates.

The structure of the paper is that of all compulsory questions, with questions 1, 2 and 3 being 25 marks each, question 4 is 15 marks and question 5 is 10 marks.

Once again it was the computational elements of the paper that were best answered; analysis and discussion were generally weaker. A significant number of candidates did not even attempt the written elements of the paper effectively sacrificing nearly 30 potential marks. It is very difficult for a candidate to pass this paper by relying entirely on their computational ability.

A relatively small number of candidates did not give workings for some of the complex figures, making it very difficult for markers to award proportionate credit if the calculations were incorrect. By contrast some candidates took the provision of workings to an unnecessary extreme thereby wasting considerable time with no real gain. For many calculations (say in the income statement) it is sufficient to show the make up of the figures in brackets as part of the line item, only complex calculations need separate workings.

Poor handwriting, bordering on illegible, continues to be a problem for a minority of candidates, if a marker cannot read (part of) a script, it cannot be given any marks.

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 was on the customary topic of cash flows and interpretation, but was more 'focussed' than some recent questions and returned mixed results. Question 4 on the definition and application of non-current assets scored reasonably well where it was attempted. The remaining question 5 on different measures of

profit/earnings performance and earnings per share calculations was the least attempted question and rather polarised in its answers (from either 1 or 2 or jumping to 7 or more).

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 streams of paper. An exception to this was that in question 1 the requirements of IFRS 3 Business Combinations required the goodwill and non-controlling interest to be a different calculation to that of UK based answers.

Specific Comments

Question One

Required calculation of consolidated goodwill (a)(i), the carrying amount of an associate (a)(ii) and the preparation of a consolidated income statement (b) of a parent and a single subsidiary and an associate 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 unrealised profits on inventory.

This was generally well answered; most candidates have grasped the main principles of consolidation with only the more complex aspects posing problems.

There were a very small minority of candidates that used proportional consolidation (for the associate and some even for the subsidiary) and a similar number failed to time apportion the consolidation. This gave the impression that such candidates have never practised any past questions.

The main areas where candidates made errors were:

In part (a) calculation of goodwill and associate:

- generally well answered (gaining 4 or 5 from 6 marks), but very few candidates correctly allowed for the interest on an 8% loan being entirely charged to the post-acquisition period (it was treated as accruing evenly throughout the period) when calculating the retained earnings at the date of acquisition. A significant number of candidates sitting International Standards based papers did not calculate the non-controlling interest at its (full) fair value (the 'new' method under IFRS 3), instead calculating it at the proportionate share of the fair value of the subsidiary's net assets.
- the calculation of the carrying amount of the associate was also very good, often gaining full marks. The main problems were not apportioning (by 6/12) the losses in the year of acquisition and not applying the 40% group holding percentage. Some treated the losses as profits.

The consolidated income statement (b). Again well-prepared candidates gained good marks with most understanding the general principles. The main errors were with the more complex adjustments:

- a full year's additional depreciation of the plant was charged, but it should have been only for the post-acquisition period of six months
- many candidates incorrectly amortised the domain name; its registration was renewable indefinitely at negligible cost so it should not have been amortised
- surprisingly a number of candidates incorrectly calculated the URP on inventory by treating the gross profit of 25% as if it were a mark up on cost of 25%
- the elimination of intra-group dividend was often ignored or the full $8 million was eliminated instead of 80% of it; similar problems occurred with the elimination of intra-group interest

- often the trading and impairment losses of the associate were ignored in preparing the income statement
- the non-controlling interest was frequently ignored and where it was calculated, many forgot to adjust for the additional depreciation on the fair value of the plant.

Despite the above, this was the best answered question and many candidates gained good marks.

Question Two

A 'familiar' question requiring candidates to prepare a statement of comprehensive income and a statement of financial position. A series of adjustments were required: for deferred revenue, a dividend paid, an effective interest rate calculation, gains on an available-for-sale investment, basic depreciation, taxation and the impairment and amortisation of a brand.

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:

- few candidates correctly calculated the amount of revenue to be deferred in relation to a sale (of $16 million) with ongoing service support. Most candidates deferred the whole of the revenue rather than the amount of the support costs (plus appropriate profit) relating to the remaining two years of service support. Some candidates increased revenue rather than defer it and some thought it was an in-substance loan
- many candidates applied the effective rate of interest (8%) to the nominal amount ($20 million) of a convertible loan rather than its carrying amount of $18.44 million. A few candidates made complicated calculations of the split between debt and equity for the loan not realising that it was the second year after its issue and the split had been made a year before
- most candidates correctly calculated the gains on the available-for-sale investment but had difficulty in knowing where it should appear in the financial statements, in particular, few correctly reclassified the previous gains from the comprehensive income statement ('other' reserve for UK based papers).
- most candidates got the taxation aspects correct, but there were still some basic errors such as charging the whole of the deferred tax provision to income (rather than the movement) and treating the underpayment of tax in the previous period as a credit.
- it was worrying that a number of candidates made basic errors on straight forward depreciation calculations. Some used the straight line method for the plant (not reading the question properly which stated the use of the reducing balance method) and some charged the accumulated depreciation to cost of sales rather than the charge for the period. Amortisation and impairment of the brand caused many problems; not calculating two 6 month charges (before and after the impairment) and not using the (higher) realisable value of the brand as the basis for the impairment charge.

The statement of financial position was generally well answered; most problems were follow on errors from mistakes made in the income statement.

A number of candidates are still incorrectly treating dividends as part of the income statement.

Overall a well-answered question.

Question Three

This question was on the 'usual' topic of cash flows and the calculation and interpretation of ratios, but was somewhat different to many previous questions in that it was more targeted on particular items. Part (a) required a statement of the movement in the company's non-current assets followed by the (partly) related cash flows of investing and financing activities. Part (b) then required candidates to focus on the calculation and cause of the deterioration in the company's ROCE.

Many candidates gave a good attempt at the movement of non-current assets; most coped with an increase in the 'cost' of an asset due to an environmental provision and recognising (per the question) that the balance of the movement represented the purchase of plant. Weaker candidates showed poor layouts often using ledger accounts with no summary showing the movement on the assets. A number did not include the movement on the development costs.

The required cash flows proved more problematic; common errors were the environmental cost increase being treated as a cash flow and very few accurately accounted for the cash flow aspects of a partial loan to equity conversion.

Again there were a small minority of poor (and sometimes non-existent) answers; some included revaluations, depreciation and reserve movements as cash flows. A number of candidates attempted a full cash flow statement instead of the required extracts.

Part (b) was very poorly answered, though there were some notable exceptions. Very few correct answers were given for the calculation of ROCE (despite the question giving the formula to apply) and even fewer attempted to calculate the components of the ROCE (profit margins and asset turnover) in order to identify the cause of its deterioration. Many candidates mentioned the new lease agreement; changes in capital structure and the asset revaluation without saying what effect these had had on the ROCE. Many candidates showed poor understanding by saying the 'return' had deteriorated due to higher finance cost when the 'return' was, by definition, before finance costs.

Question Four

Part (a) asked candidates to criticise the definition included in the question of non-current assets that had been given by an assistant. Many candidates did not directly criticise the points in the assistant's definition, instead they gave the definition of non-current assets as per the IASB Framework without comparing it to the given definition. This is a classic example of not answering the question that was asked. Good answers did focus on issues of control (rather than ownership) and reference to intangible assets as well, as 'physical' assets. Some answers 'rambled on' giving examples of every type of non-current assets the candidate could think of (again nothing to do with the question asked).

Part (b) gave three examples of how the assistant had treated items in the financial statements and asked candidates to comment (and advise) on their treatment.
Item (i) was expenditure on staff training costs that the assistant wanted to treat as an intangible assets. Most candidates realised that such costs could not be treated as an asset and should be expensed, but very few said why.
Item (ii) gave two examples of research expenditure. Again most candidates correctly said that (in most cases) research cannot be treated as an asset. Despite saying this some candidates thought that as the company had a successful history of bringing projects similar to the first example to profitable conclusions, it was acceptable to treat these research costs as an asset. The second example was research commissioned by a customer and as such was in fact work-in-progress and therefore should not have been written off (as suggested by the assistant). Even where candidates did advocate the correct treatment, they rarely explained why.

The last item (iii) caused most difficulty. It was about whether expenditure on a partially completed non-current asset (a satellite dish system) was impaired. The assistant thought it was because the expected profit from the asset was less than the amount already spent on it. What most candidates failed to realise was that the asset would only be impaired where the recoverable amount, being the value in use (based on future cash flows, not profit), was less than the carrying amount (ignoring the possibility of selling the asset).

Many candidates thought this was a (long-term) construction contract, presumably because the asset would be used to earn revenue for at least three years. In fact the period of construction of the asset was only two months and the contract was for the rental (not the construction) of the asset (the question specifically said that it was not a finance lease). This showed a fundamental lack of understanding of what construction contracts are.

Question Five

Part (a) of this question asked candidates to explain why three different measures of performance for the same company (profit after tax, basic EPS and diluted EPS) gave different impressions of increased performance. This seemed to baffle most candidates. Where candidates did try to explain this, they gave examples of improvements in profit performance that would apply to the other measures of performance. An increase in profit of 80% (as per the question) would also give an increase of 80% in the EPS if there was no change in the capital structure. Few candidates could relate the given differentials to new shares being issued. A number of candidates did realise that the diluted EPS was something to do with convertible shares or share options.

Part (b) of the question was a calculation of basic and diluted EPS. Encouragingly this was answered much better and redeemed the question for many. There were some poor answers showing basic errors, commonly thinking that the rights issue caused the dilution rather than the existence of the convertible loan stock. Less worrying errors were incorrect weighting of the rights issue and getting the dilution factor the wrong way round (the inverse). Weaker candidates calculated many meaningless figures that were scattered, seemingly randomly, all over the page and expected the marker to make sense of them.

Conclusion

As reported in the introduction, the overall performance of candidates was a welcome reversal of the poor pass rate in June 2009. However, there are still too many candidates trying to pass by just learning the main topics or relying on numerical skills alone. Weaker candidates were making some basic errors that revealed a lack of understanding of F3 level topics and as such could not give this F7 paper a fair attempt.

It should be borne in mind that many of the above comments on the individual questions focus on the errors made by candidates. 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.