



Examiner's approach

Paper F7

The aims of Paper F7, *Financial Reporting* are to develop knowledge and skills in understanding and applying accounting standards and the theoretical framework in the preparation of financial statements of entities, including groups, and how to analyse and interpret those financial statements. The paper also forms the basis of the assumed knowledge required in Paper P2, *Corporate Reporting*.

On successful completion of Paper F7, candidates should be able to:

- discuss and apply a conceptual framework for accounting
- discuss a regulatory framework for financial reporting
- prepare and present financial statements that conform with International Financial Reporting Standards (IFRS)
- account for business combinations in accordance with IFRS
- analyse and interpret financial statements.

Paper F7 builds on the knowledge and skills acquired from Paper F3, *Financial Accounting*. Paper F7 will provide the platform for progression to Paper P2, *Corporate Reporting* and (to a lesser extent) to Paper P3, *Business Analysis*. Knowledge obtained from studies of financial reporting will also be very relevant to many aspects of the Paper F8, *Audit and Assurance* syllabus.

As indicated, a substantial element of Paper F7, *Financial Reporting* is the requirement to understand and apply accounting standards. Not all accounting standards are examinable; the examinable documents for each paper are regularly updated and published in *student accountant*.

Modern accounting standards can be very detailed and complex, and it would be inappropriate to expect candidates at this level to have a complete knowledge of such standards. Therefore, candidates will be expected to understand the main principles and objectives of accounting standards, and to be able to apply these when required to produce financial statements that are made available publicly (often referred to as published accounts questions) and in scenario questions.

A further important aspect of the syllabus is the theoretical and conceptual issues that underpin both accounting standards and generally accepted accounting principles, and the regulatory issues controlling the reporting of financial information to users. Much of the conceptual knowledge is to be found in the IASB's Framework for the Preparation and Presentation of Financial Statements (Framework), whereas an understanding of the role of the IASB is an important element of the regulatory framework.

The concept of business combinations, and the preparation of consolidated financial statements (group accounts), is introduced to students in Paper F7. Accounting for business combinations can be seen as a progression from preparing the financial statements of a single entity. Consolidation questions will be limited to a parent company and one subsidiary, with the possible inclusion of an associate that will require equity accounting. It should be noted that joint ventures are not examinable in Paper F7 (they were included in Paper 2.5).

Candidates may observe that some accounting standards appear in all three financial accounting papers. This illustrates the relationship between the papers, and reflects the continuity and progression of the syllabus. Where a topic that appears in Paper F3 is also included in Paper F7, any examination of that topic will be at a higher level, requiring greater understanding and appropriately higher skills.

The final element of the syllabus is the analysis and interpretation of financial statements. This section also includes the preparation and interpretation of cash flow statements, which should be seen as playing an important role in the assessment of an entity's financial position. Along with basic group accounting, this is also an area that was previously included at a lower level, but is now examined for the first time in Paper F7. As a result, questions are expected to include more calculation of ratios, and a requirement to explain what particular ratios are intended to measure.

To summarise, candidates need to understand the theory and concepts underlying the preparation and regulation of an entity's financial reports, to apply their knowledge of accounting standards to prepare financial statements of both single entities and groups, and finally, to demonstrate their analytical skills to assess the performance of entities based on the information provided by those financial statements.

Format and structure of the examination

The three-hour examination will comprise five compulsory questions, which differs from the format of the previous equivalent paper (Paper 2.5) where there was an element of choice. One of the reasons for this change is to counter what seemed to be a growing practice of only studying the 'core' topics (groups, published accounts, and interpretation). Such a strategy is very short term; it does not provide the breadth of knowledge required for progression to the Professional level nor does it provide the background knowledge required for workplace development. To further encourage broader study, candidates should be aware that an individual question may often involve elements that relate to different subject areas of the syllabus.

Question 1

This will be a 25-mark question on aspects of business combinations. It will be largely computational (at least 20 marks), and may have a short written element. The computational element will test consolidated income statements and/or balance sheets. It will include no more than one subsidiary, but possibly also an associate. Candidates will need to master the concept of pre- and post-acquisition profits, calculation of goodwill and minority interests, and deal with fair value adjustments and elimination of intra-group transactions. The written element will test some of the principles of business combinations, such as the definition of a subsidiary, why an associate is equity accounted for, why it is necessary to use fair values for the subsidiary, and why intra-group transactions are eliminated. Past experience reveals that candidates are often very capable in the techniques of preparing group financial statements but, when asked, do not really know what these techniques achieve.

The question in the *Pilot Paper* suitably illustrates these points. It requires the consolidation of a subsidiary and equity accounting of an associate. This is preceded by a requirement to discuss how (and, implicitly, why) the three investments of the parent should be treated: there is control of one so it is a subsidiary, there is (presumed) influence over another so it is an associate, and the final investment is a loan to the subsidiary – which is an intra-group cancelling item.

Question 2

This will be a 25-mark question requiring the preparation (or restatement) of a single entity's financial statements. Information may be in the form of a trial balance accompanied by several notes that will need to be taken into account in preparing the financial statements. Alternatively, draft financial statements may be given that require adjustment and restatement for several items in accompanying notes. This question will be similar to the style and format of Question 2 in the previous Paper 2.5 exam. A common feature of this type of question is that it may include material from several topic areas and require the application of several accounting standards. For example, it may require accounting for a finance lease, the revaluation or impairment (and subsequent depreciation) of non-current assets, dealing with investment properties, issues of shares and loan notes, and calculating earnings per share figures. Occasionally, candidates may be asked to comment on the appropriateness or acceptability of management's opinion or chosen accounting treatment. The *Pilot Paper* question is typical of what can be expected.

Question 3

This will be a 25-mark question on aspects of the analysis and interpretation of financial statements. It will be similar to Question 4 in the Paper 2.5 examination. It may require the preparation of a cash flow statement and the calculation of certain ratios prior to their analysis. The scenario of the question may be quite varied, perhaps

comparing two companies with a view to a prospective purchaser acquiring one of them. It may be to assist management in determining how corporate actions may have affected an entity's performance (similar to the *Pilot Paper* question). Candidates will need an awareness of how certain transactions or events may have affected a valid comparison. For example, the revaluation of a property during a period will affect return on capital employed, compared to what it would have been had it not been revalued. This is important when considering trend analysis. It is in this question that reference may be made to specialised, not-for-profit, and public sector entities as in the *Pilot Paper*. The Paper 2.5 syllabus (and examination notes) contained material on IFRS 8, *Operating Segments*, and IAS 24, *Related Parties*. These do not appear in the new syllabus. The main reason for this is that these standards contain many detailed definitions and disclosure requirements that can be learned by rote, and therefore do not merit detailed examination at this level. However, the effect that related parties can have on an entity's financial statements is potentially very material, and candidates will be expected to be aware of this possibility when interpreting an entity's financial statements (related party effects may also be important within business combinations). Occasionally, the interpretation question may be set in a segmental scenario. Note that neither of these possibilities will require specific knowledge of IFRS 8 or IAS 24.

Questions 4 and 5

Questions 4 (15 marks) and 5 (10 marks) will cover the remainder of the syllabus. Within these questions, the Framework and accounting concepts will be a familiar theme, often related to practical examples of their application. For example, Question 4 of the *Pilot Paper* asks about the qualitative characteristics of information, and follows this up with three small examples of accounting treatment based on one or more of these characteristics. Question 5, on construction contracts, is preceded by a consideration of the (conceptual) issues of revenue recognition as applied to the particular circumstances of construction contracts (ie their durations normally span two or more accounting period-ends).

Conclusion

I hope the above will be of assistance to candidates and tutors. This article should be read in conjunction with other related published material including the *Syllabus*, *Study Guide*, and *Pilot Paper*.

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