

# Examiner's report

## F7 Financial Reporting

June 2014



### General Comments

The paper was regarded by most commentators as a fair test of familiar topics which a well-prepared candidate should have comfortably passed and that candidates' results maintained a satisfactory performance.

The best answered questions were the core questions on consolidated financial statements (Q1) and the preparation of a single company's financial statements (Q2). The ratios required in question 3 were also generally very well answered. This gave most candidates a strong base on which to attempt the rather less predictable questions 4 and 5. Another welcome feature of this diet was that more candidates attempted all five questions although marks earned on questions 4 and 5 were generally much lower than on the other parts of the paper

However, there were still some examples of poor examination technique; for instance not reading (or thinking about) the question requirement carefully enough, thus misinterpreting what was required (particularly in Q5 (i) and Q5 (iii)).

Other issues relating to poor examination technique included: (i) a lack of cross-referenced understandable workings; (ii) poor handwriting that many markers struggled to read; and (iii) the needless repetition of figures and/or question requirements which resulted in a waste of the candidates' time.

### Specific Comments

#### Question One

Part (a) required the calculation of consolidated goodwill dealing with a share exchange and deferred consideration as well as fair value adjustments for land and plant and the recognition of a separate sales-related intangible asset (good customer trading relationships).

Part (b) required the preparation of a consolidated statement of profit or loss including the results of an associate. Some 'familiar' adjustments were required: (i) time apportionment of the subsidiary's results; (ii) intra-group trading and unrealised profits (URP); (iii) additional depreciation of plant and amortisation of the intangible asset from the fair value exercise; (iv) unwinding of part of the deferred consideration; and (v) dealing with post-acquisition increases in the value of land for the subsidiary.

The majority of candidates displayed a reasonable working knowledge of consolidation techniques and thereby gained appropriate marks. However, there is still a small minority of candidates who used proportional consolidation for the subsidiary and some did not time apportion the subsidiary's results to reflect the mid-year acquisition.

For the benefit of future candidates, the most common errors were:

#### Consolidated goodwill

- Not discounting the deferred consideration by 10% (and consequently not making a finance charge in the six months post-acquisition period), although credit was given for a finance charge based on non-discounted consideration.
- Omitting the value of non-controlling interests in the calculation or using the share price of the parent \$4 (rather than the share price of the subsidiary at the date of acquisition \$2.50).
- Incorrectly calculating the subsidiary's retained earnings at the date of acquisition and not realising that the sales-related intangible asset required separate recognition from goodwill itself.



- Time apportioning the share capital, retained earnings brought forward and the fair value adjustments which suggest a lack of understanding. Some candidates included post-acquisition additional depreciation/amortisation charges in the calculation of goodwill (these amounts should be reported in profit or loss).

Consolidated statement of comprehensive income.

- A small number of candidates deducted the closing inventory (\$4 million) from revenue and cost of sales instead of all of the intra-group sales (\$20 million). A number of candidates also deducted the sales to the associate of \$15 million from revenue and cost of sales, even though these were not part of the consolidated figures. The URP for the associate was often deducted in full at \$3 million, rather than correct figure of \$900,000, based on the parent's holding (30%) in the associate. Many candidates adjusted this URP (in whole or in part) against the profit of the associate, not recognising that it was the parent that had made the sales to the associate (a "downstream" transaction).
- Additional depreciation/amortisation charges were often not time apportioned (even where other profit or loss figures had been).
- Most candidates did not correctly account for the investment income which should have been reported as two separate elements: firstly, from the associate being 30% of earnings (profit after tax) for the post-acquisition six months (many incorrectly based this on the *retained* earnings or the dividend received or even added the dividend received back to profit after tax) and secondly, other investment income where many candidates did not deduct the dividend received from the associate (although some candidates deducted *all* of the associate's dividend).
- As mentioned above, many candidates either totally ignored the finance costs of the deferred consideration or did not time apportion it.
- A very common error occurred with the reporting of other comprehensive income, most candidates (who attempted this part at all) time apportioned the annual increase in the value of the subsidiary's land to get a post-acquisition increase of \$1.5 million (\$3 million x 6/12), whereas, as per the question, it should have been split \$2 million pre-acquisition and \$1 million post-acquisition.
- The non-controlling interest in the profit for the year was generally well done, but many candidates did not attempt the equivalent figure for total comprehensive income.

### Question Two

This question required the traditional preparation of a single company's financial statements (statements of profit or loss, changes in equity and financial position) from a trial balance combined with several adjustments including: (i) an agency sale; (ii) basic depreciation; (iii) the issue of a convertible loan note (using the effective interest rate);(iv) a rights issue of shares and dividends paid pre-and post-rights;(v) provision for taxation including deferred tax and (vi) basic earnings per share (EPS).

This question was generally well answered with most candidates showing a sound knowledge of preparing financial statements in this format. Most errors occurred within the following adjustments:

The effect of the agency sale was generally well understood in the statement of profit or loss (although some calculated the commission on the remittances rather than the actual sales), however, surprisingly few candidates accounted for the net payable (\$3 million) owed to the principal in the statement of financial position. Markers accepted the agency income of \$2 million in either revenue or as other income.

The rights issue (which should have been reported in the statement of changes in equity) caused several problems and the most common was that candidates applied the rights issue to the share capital and share premium in the trial balance. However the question stated the rights issue had already been recorded indicating that the trial balance figures already included the issue. In effect, candidates had to work backwards (to the opening balances) when preparing the statement of changes in equity. Another error candidates made was taking the shares as denominated at \$1 whereas they were actually denominated at 25 cents (this also affected the dividend calculations).

Most candidates had a reasonable attempt at recording the split between debt and the equity option of the convertible loan note, but there were several common errors:

- using a 5% discount rate rather than the effective (interest) rate of 8%
  - charging the interest paid of \$2.5 million (at 5%) to profit or loss (even where the candidate had used the correct 8% when discounting)
  - some candidates worked on the basis that the reporting date was two years after issue (it was one year)
  - not including the equity option in the statement of changes in equity (some credit was given where this first appeared in the statement of financial position under equity).

Most candidates handled the taxation adjustment well, but there were some errors in identifying whether the previous year's tax provision and the movement in deferred tax were debits or credits and incorrect figures thus appeared in both the statement of profit or loss and the statement of financial position.

The last part of the question asked for a calculation of the basic EPS which was complicated by the rights issue. This seemed a familiar topic and most scored well. There were some errors in the calculation of the theoretical ex-rights value (TERV), incorrect application of the dilution factor and some candidates miscalculated the date of the issue at three months (or five months) into the financial year (it was four months).

Other errors included:

- the application of the plant depreciation rate ( 12 ½% per annum) to the 20 year leased property, followed by depreciating plant and equipment at 12½% based on cost (rather than reducing balance).
  - no attempt to properly account for the loan note (or its finance cost), leaving it at \$50 million (and \$2.5 million)
  - including the bank overdraft incorrectly in current assets and/or showing bank interest as income
  - showing dividends (however calculated) as an expense
  - no attempt at the statement of changes in equity or the EPS (9 marks in total)

It is worth mentioning that, in this type of question, an error in an earlier part often follows through to create a further error in a later calculation (often called a 'knock on' error). These knock on errors are not penalised as ACCA adopt a 'method marking' principle which means the same error is not penalised twice and this was particularly the case in the marking of this question.

### Question Three

This question required candidates to calculate two sets of specified ratios for a company (Woodbank) and use these to provide a previous year comparative analysis of the performance of the company. The calculation of the first set of ratios was quite straightforward and most candidates achieved high marks for these. The second set of ratios required more work as the exclusion of the results of a newly-acquired business (Shaw) from the overall results was required. These ratios were designed to help portray the underlying performance on a like-for-like basis. Although marks for this second group of ratios were not as high as for the first, most candidates gained good marks with the exception of net asset turnover which, specifically by computing it the wrong way round (as capital employed/revenue). ROCE also proved difficult where candidates did not add back finance costs (or sometimes did not include the loan as part of capital employed). A few candidates did not attempt to calculate the second set of ratios at all, and some calculated the ratios of the newly-acquired business (Shaw) itself instead of those of the Woodbank excluding the results of Shaw as asked for.

As usual with this type of question, it was the interpretation of the ratios that separated well-prepared candidates from the others. Those candidates that did not score well simply stated that a ratio has increased or decreased, without saying whether it is good or bad, or without offering any reason as to *why* an increase/decrease may have happened; this is not an interpretation in any meaningful sense.

In their interpretation, many candidates paid too little regard to the incremental effect of the acquisition of Shaw, even though the question specially asked for it. Likewise, few candidates commented on the fact that the reported statement of profit or loss only included the results of Shaw for a three month period; the implication being that in the next accounting period much higher profit or loss figures could be expected from Shaw, thereby contributing positively to Woodbank's results. This 'distortion' is worse for ratios that combine profit or loss figures with figures from the statement of financial position (for example, ROCE and net asset turnover). This is because the former only includes 3/12ths of the expected results of Shaw, whereas the latter includes all of the net assets of Shaw at the reporting date.

This phenomenon was not properly understood by most candidates. To illustrate, take the figures for ROCE; the reported figures showed an improved ROCE from 10.5% in 2013 to 12% in 2014; however the ROCE for 2014 excluding Shaw was 13%. This led many candidates to suggest that the acquisition was not advantageous to Woodbank (as the ROCE would have been higher without the new business). This is illusory because, if there had been a full year's results of Shaw included in the profit or loss figures (which in future there would be), the ROCE of the combined business would be much higher than 12%. Although the actual calculation of this figure was not expected it would be 22% (returns of \$13 million from Woodbank plus annualised \$20 million from Shaw on capital employed of \$150 million). Very few candidates appreciated that Woodbank had paid a dividend of \$5.5 million in 2014 (from working through the change in retained earnings).

Other aspects of the interpretation were generally quite good:

- appropriately valid comments on the declining liquidity, due mainly to a fall in the bank, which in turn was mainly caused by paying a \$5.5 million dividend (though many candidates spent a lot of time calculating other liquidity and working capital ratios that were not asked for)
- identifying a much higher level of gearing (although still within acceptable limits) caused by financing the acquisition of Shaw solely from increased borrowings
- reasonable conclusions summarising the main aspects of the interpretation.

Overall the performance on this question was very mixed with too much reliance on scoring marks on just the ratio calculations.

#### Question Four

This question was on the familiar area of the IAS 16 *Property, plant and equipment*.

Part (a) was a written section requiring candidates to explain the requirements of IAS 16 in relation to the revaluation and subsequent accounting of property, plant and equipment in response to a concern that traditional (depreciated) historical cost 'undervalues' assets on the statement of financial position. The candidates' answers were mixed, however, some did obtain full marks. Many candidates discussed what could be capitalised as part of the cost of non-current assets; this wasted time as, although this has been a topic of previous questions, it is not related to the requirements of this question. Weaker candidates also spent most of their answer discussing the cost model of valuing non-current assets, different methods of depreciation or elaborating in detail on the depreciation charge depending whether a revaluation was at the start or the end of a financial period. A number of candidates also took the question to be about the nature and treatment of impairment (which it wasn't) and many candidates insisted that assets had to be revalued every year. It is very important to read the requirements of the question and ensure that your answer satisfies these requirements.

Part (b) was a numerical example of applying IAS 16, including revaluations. Candidates had to calculate how two assets would be reported in the financial statements over a two-year period. It contained most elements relating to non-current assets: (i) revaluation surplus and deficit; (ii) depreciation based on revalued amounts and remaining lives; (iii) subsequent expenditure to be capitalised; (iv) transfer of the revaluation surplus (reserve) to retained earnings and; (v) a profit on disposal.

Most candidates were reasonably competent in this area although there were a number of errors:

- offsetting the revaluation deficit against the revaluation surplus (the correct treatment is that a surplus goes to reserves (via other comprehensive income) whereas a deficit is charged immediately to profit or loss). This particular error was made frequently.
- not following through the transfer of "excess" depreciation to retained earnings in 2013 and transferring the remainder of the revaluation surplus to retained earnings in 2014 on the sale/realisation of the asset
- not capitalising the subsequent expenditure or not depreciating over the remaining life after capitalisation (i.e. over four, not five, years)
- ignoring the disposal or including the asset in the statement of financial position after it had been sold (sometimes showing the asset sold as "held for sale" when it had already been sold).

The main problem for markers on this question was that many candidates gave a working schedule for each asset without actually preparing (relatively short) extracts from the statement of profit or loss or the statement of financial position that were asked for, in effect, asking the marker to do much of the work.

#### Question Five

This question concerned the accounting treatment of three unrelated items: (i) a change in accounting policy; (ii) whether and how much to provide for two liabilities (provisions); and (iii) the treatment of a government grant.



Many candidates did not attempt this question and those that did showed very mixed abilities.

(i) This was about the validity of the directors' decision to change the classification of research and amortised development costs from cost of sales to administrative expenses because of the favourable effect this has on the gross profit margin. Far too many candidates thought the question was about the circumstances where development costs should be capitalised or written off (and often wrote a full wasted page on this area). In doing so, they missed the point of the question, which was about requirements relating to a change in accounting policy (albeit framed as the classification of research and development costs). The answer simply required candidates to recognise this was a change of accounting policy, discuss the circumstances where these are permitted and the effect on comparatives by retrospective application.

(ii) This part was answered much better, with many of the candidates who did answer it gaining full marks. Candidates were required to identify that a liability for an ongoing court case should be recognised as a provision at the most likely outcome (the 65% probability) for \$4 million. By contrast, the second liability was for outstanding product warranties which required a provision based on expected values. The errors that occurred included taking an expected value approach to the court case and concluding that the warranties were a contingent, rather than an actual, liability.

(iii) In this scenario the directors wanted to take credit for a government grant in relation to the stages (in time) when it became no longer repayable. This treatment is incorrect as government grants must be credited to profit or loss in relation to the life of the asset to which they relate (not any potential repayment schedule). This is especially the case when there is no intention of selling the related asset.

A few candidates thought that the directors' proposal was acceptable, and most were not fully aware of the grant's correct treatment in the financial statements. Many candidates wasted time by discussing the accounting treatment of the related plant which was not required or insisted that the grant should be deducted from the cost of the asset, even though the question clearly stated that the alternative deferred income approach was used.

## **Conclusion**

Overall this was an encouraging performance with many candidates displaying good knowledge and technique.

Many of the above comments on the individual questions focus on where candidates made errors. This is intended to guide candidates' future studies and to highlight poor techniques with a view to improving future performance. This may appear to give an overly pessimistic view of candidates' performance. This is not the intention, nor is it necessarily the case. There were many excellent scripts that were rewarded appropriately.