Examiner's report

F7 Financial Reporting
June 2010

General Comments
I am very disappointed to have to report a marked deterioration in candidate's overall performance for this diet of the F7 Financial Reporting examination. Most commentators considered the paper to be no more complex or demanding than in recent previous diets. The majority of the paper's topics had been examined before and candidates who had studied the full syllabus and revised using recent past questions should have had no difficulties obtaining a pass mark. It was particularly worryingly that so many candidates failed to gain enough marks to demonstrate any progression of understanding from that required at paper F3. Indeed some of the easier computations on this paper such as basic depreciation and accruals were not done correctly, in extreme cases some candidates made fundamental errors such as including non-current assets as income and conversely showing investment income as an asset.

This report has two main functions; firstly, 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.

Other causes of the poor performance are familiar, but more prevalent than in the past. The most common of these was a failure to answer all the questions. A significant number of candidates gave answers to only half of the paper and thus had no hope of passing. One marker reported that she had lost count of the number of candidates that had scored 35 – 40 marks after completing the paper up to Q3 (a)(i) (which is 62 marks into the paper) and then failed to score more than another 5 marks on the rest of the questions (accounting for the remaining 38 marks). Many answers to written questions did not address the specific points asked for indicating a lack of focus or simply not reading the requirement properly.

As on all recent sittings the written elements were answered much worse (if at all) than the computational elements. A number of candidates displayed evidence of poor time management by producing pages of unnecessarily detailed workings for even simple calculations. A consequence of this was running out of time on the later questions.

The structure of the paper is that of all compulsory questions, with questions 1, 2 and 3 being for 25 marks each and questions 4 and 5 are for 15 and 10 marks respectively. The first three questions cover the 'core' topics of consolidated accounts, preparing single company financial statements (on this paper, from a trial balance) and performance appraisal/cash flows. Questions 4 and 5 cover the reminder of the syllabus.

Overall candidates' performance can be summarised as good to very good on questions 1(a), question 2 and the statement of cash flows of 3(a)(i); beyond this the rest of the answers were poor, very poor or non-existent.
Candidates should be aware that markers may not be able to give credit to answers that displayed poor, sometimes illegible, handwriting. There were also many unreferenced or non-titled/labelled workings which can hinder the marking process.

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.

Specific Comments

Question One
This question required (in part (a)) the preparation of a consolidated statement of financial position (balance sheet) for a parent, a subsidiary and an equity accounted associate. The question specifically required the calculation of consolidated goodwill (involving contingent consideration and two fair value adjustments), intra-group adjustments and an impairment of goodwill. Part (b) was a 4 mark written section.

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The preparation of the consolidated statement of financial position was generally well answered, but answers to the written section were very mixed.

The main errors by candidates in the consolidation were:

- goodwill calculation: using an incorrect share price for the share issue and incorrectly revising the value of the contingent consideration as a goodwill adjustment (it should be to retained earnings) [Note: for UK-based papers it is correct to adjust the goodwill]. Incorrectly or not adjusting for software that had no recoverable value. Also a number of candidates failed to include the non-controlling interest at its fair value with the consequential effect on goodwill [not applicable to UK-based papers].
- the adjustment to the value of the software was also often written off the value of non-currents (even though the question said it had already been written off) and rarely was it accounted for as part of the subsidiary's post acquisition profit calculation.
- the intra-group adjustments for goods-in-transit, URP (often calculated incorrectly) and current account balances were often wrong with no clear pattern of mistakes; just about every combination of error was reported
- the profit of the associate was often not time apportioned
- the impairment of goodwill was not apportioned between the parent and non-controlling interest [not applicable to UK-based papers]
- a lot of errors/omissions made in earlier calculations were carried through to the calculation of consolidated retained earnings
- some candidates accounted for the share exchange issue (effectively double counting it) even though the question said it had already been accounted for
- some answers used proportional consolidation for the associate (some even proportionally consolidated the subsidiary); others consolidated the associate (rather than using equity accounting) - thankfully this is now only a tiny minority of candidates.

Despite the above this section was well answered.

Part (b) was a short (4 marks) written section testing candidate knowledge of the legal position of a subsidiary within the context of group financial statements. The subsidiary provided a copy of the group's consolidated financial statements to support an application for credit. Answers to this were generally poor and even alarming. The majority of candidates thought that a parent (or other subsidiaries) was responsible for the debts of its subsidiary. This is not the case. Without a guarantee from the parent, a strong group statement of financial position does not give any assurance to a potential creditor of a subsidiary. It is essential to base any extension of credit on the individual (entity) financial statements of the subsidiary itself. Another misinterpretation of this section was that some candidates thought it was a question on ratio analysis and described the ratios they would calculate to determine the liquidity position of the group.

Question Two

This was a familiar question of preparing financial statements from a trial balance with various adjustments required. These involved the dealing with a sales 'cut off' error, the use of the effective interest rate for a loan, a fair valued investment, an impairment of a leasehold property (including presenting it as 'held for sale' – International variants only), a construction contract and accounting for taxation.

As with question 1, this question was competently answered by the majority of candidates showing good knowledge of the format and presentation of the two financial statements.
To help with future preparation, the most common errors were:

- 'cut off error': generally dealt with quite well, but there were errors in grossing up the cost (or only adjusting by the profit element) to give the correct revenue/turnover figure
- loan: the issue costs were often ignored (they should have been deducted from the proceeds and also deducted from administrative expenses) and calculating the finance charge at the nominal rate of 5%

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instead of the effective rate of 10%. Omission of accrued interest from current liabilities or including it at the incorrect amount

- despite the investment being described as 'fair value through profit and loss', many candidates credited the gain directly to equity
- leasehold property: a failure to depreciate it up to the date it became 'held for sale'; not calculating the subsequent impairment loss and most candidates continuing to show it as a non-current (rather than a current) asset [the latter point not applicable to UK based papers]
- construction contract: often completely ignored, incorrect calculation of cost (usually omitting the plant depreciation), incorrect (or non-existent) presentation in current assets (amount due from customers) or non-current assets (carrying amount of the plant). A lot of candidates who prepared workings for the contract then made no attempt to include the relevant figures in their financial statements.
- there were many errors in the treatment of the taxation in both the income statement and the statement of financial position, these included: debiting (should be credited) the over provision of the previous year's tax; treating the closing provision (rather than the movement) of deferred tax as the charge in the income statement; and confusion over which amounts of tax should appear as non-current and current liabilities.
- a number of candidates are still showing equity dividends in the income statement (as an expense) rather than as part of the calculation of retained earnings.

Question Three

This question was on the familiar topic area of cash flows and interpretation and was widely expected. Part (a)(i) required the preparation of a statement of cash flows for 12 marks followed by some focused interpretation to be able to advise the loan provider on the possible renewal of a loan (8 marks).

Cash flows remain popular with candidates and those that had practiced past questions generally scored well. There were a couple of tricky areas that confused candidates: non-current assets had only increased by new finance lease agreements (which candidates did not take into account when calculating the payment of the finance lease liability); and the taxation cash flow involved tax relief and a future refund to compute the tax paid during the year. A surprising error was that several candidates did not think the interest on the finance leases was a cash outflow. An analysis of retained earnings would have shown that a dividend had been paid, however only a tiny minority of candidates picked this up.

Although most candidates scored well on the cash flows, a significant number showed a lack of understanding including poor format knowledge.

In part (a)(ii) candidates were asked to review the available information (including their statement of cash flows) to advise on the renewal of the loan due three months after the year end. Although there were a few really good answers to this, i.e. those that focussed on the requirement, many candidates answered this as if it were a general interpretation of financial performance giving little regard to addressing the issue of whether they would advise that the loan renewal be granted.

The answer should have concentrated on the expectations of a lender: does the company have good liquidity, interest cover, acceptable gearing and securitisable assets. Good answers referred to the company selling its leasehold property and renting it back as a sign of an inability to generate cash flows from trading activity and that there was a year-end overdraft despite selling the property and issuing shares. Many weaker answers were dominated by profitability issues, such as profit ratios and cost control, and a detailed commentary on inventory and receivables policies, with hardly any reference to the position as portrayed by the statement of cash flows. Another problem was not understanding that the loan had 'moved' from non-current to current liabilities: many candidates thought that the non-current loan had been paid off and a new loan taken out. This error was also commonly presented in the answer to part (a)(i) although no cash flow(s) had taken place.

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For the first time part (b) examined an issue relating to a not-for-profit organisation. It was a similar issue to that in part (a)(ii) in that it asked for what ratios could be calculated to decide whether to grant a loan to such an organisation. Many candidates did recognise and state that a not-for-profit organisation doesn't have profits, but despite this then went on to describe many profit-related ratios without even trying to relate them to the types of income, expenses, assets and liabilities of a sports club. The question clearly stated that this was a separate matter to the earlier question. Despite this many candidates calculated (routine) ratios using the figures from the company's financial statements (Deltoid) in part (a) often referring to the sports club as "the company". What was required in answering this section was a recognition that although the sports club is a not-for-profit organisation, granting it a loan is a commercial activity and should be decided based on similar principles to that of a commercial organisation. Thus the ability to pay interest, capital and the availability of any security is still relevant.
A number of answers completely ignored what the question had asked and instead just gave a rote-learned page of everything they could remember about not-for-profit organisations such as the three E's.

Question Four
This question tested the much-examined and important topic of the principle substance over (legal) form with reference to the ASB's 'Framework'. Part (a) was a written section that should have been straightforward. It asked why this principle is important and what features may indicate that the substance of a transaction may be different from its legal form. Most answers started well referring to matters such as relevance, reliability and faithful representation. However the discussion of finance leases dominated many answers (to the exclusion of other issues) and few attempted to describe the features that may indicate a difference between substance and form such as the separation of ownership and control, the use of options and linked transactions.

Part (b) was a numerical test of the substance principle which required a short series of linked transactions to be accounted for both in their legal form and in their substance. Again, although many candidates did score some marks, it was clear that very few really understood the issues. The example was of a 'sale' and 'repurchase' of maturing inventory. When treated in its legal form a sale (and profit) should have been recorded in years one and three with no finance costs charged. The substance of the transaction was that of a secured loan where interest was the only relevant item in the income statement in years 1 and 2 and a single sale/profit (as well as further finance costs) recorded in year three. Many candidates got very confused between the two and integrated elements of the two answers, particularly incorrectly including finance costs in the answer to the legal form. Many candidates either showed statement of financial position extracts, or mixed up items to be reported, when the question clearly stated only income statement extracts were required.

Part (c) asked how the two different treatments might affect an interpretation of the company's performance. Where candidates had got the numbers correct in part (b) they tended to do quite well in this section; not surprisingly, if candidates did not understand the numbers they couldn't understand their interpretation.
The main points were that neither method affected the overall profit (over the three years) on the transactions (although many thought it did) with the main differences being in the timing of recognising profit and the classification of costs in the income statement. The more substantial differences being in the statement of financial position where, under the substance method, inventory and the loan were included as assets and liabilities respectively. This would have 'knock on' effect on ratios such as ROCE, gearing and inventory utilisation.

Question Five
This question was based on the relatively infrequently examined topic of borrowing costs and as such caught out many candidates who had not covered this in their revision. A considerable number of candidates did not attempt this question. Those that had studied the topic scored well thus answers tended to be very polarised, either very good or very poor.

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Part (a) asked for the circumstances when borrowing costs should be capitalised. This should have proved straightforward. An answer such as 'Borrowing costs relating to assets that take a substantial time to complete are capitalised at the effective rate interest from the date construction starts and should end when the asset is ready for use.' would alone have attracted at least three of the five marks available for this part. Further discussion of the suspension of capitalisation where construction activity is suspended and the deduction of any (temporary) investment income from capitalised cost would have been all that was necessary to gain the full marks.
Instead many answers just guessed at the rules or interpreted the requirement to be about what other costs could be capitalised during the construction of non-current assets (the topic of a recent past question).

Part (b) was a numerical example designed to put the above rules into practice. The main errors made by candidates were using the nominal/coupon rate of 6% instead of the effective rate of 7.5% to calculate the interest to be either capitalised or expensed and not correctly calculating the period of capitalisation. A number of candidates spent time calculating what the liability for the loan would be in the statement of financial position – this was not asked for and gained no marks.

Conclusion

As reported in the introduction, the overall performance of candidates was very disappointing with too many candidates simply not doing enough studying to prepare themselves for answering questions across the breadth of the syllabus, in effect hoping to pass by answering three questions. Poor examination technique was much to fore, particularly not reading or interpreting several of the question requirements properly, especially in respect of the written questions. The worst performing candidates did not show an understanding of F3 material and could not therefore do themselves justice. It was also apparent that many candidates had done little if any practising of recent past examination questions.

The above comments should not detract from the very able candidates who obviously worked hard and were rewarded with good marks.