Examiner's report

F7 Financial Reporting
June 2011

General Comments

The I am disappointed to report that, after a much improved performance in December 2010, the pass rates for the current diet have reversed significantly. The main cause of the decline seems to be a return of the bad habit of candidates trying to pass on the first three questions. Once again, questions 4 and 5 were not attempted by a large number of candidates. The topics of these two questions were far from being on the periphery of the syllabus. Question 4 was on the IASB's Framework, discontinued operations and earnings per share (EPS) which have all been examined many times in past papers, as too has subject matter of question 5, construction contracts. I am at a loss to explain why these topics are answered so poorly, or not at all.

Most commentators 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.

True to past performances, the best answered questions were the consolidation in question 1 and financial statements preparation in question 2. Answers to question 3 were also generally good, particularly the statement of cash flows and ratio calculations.

There are still some examination technique issues that need to be improved upon which, on their own, I feel confident would have lifted many marginal fails into the pass category. What is important about this statement is that I am saying that many candidates are failing because of technique rather than knowledge or ability. I find it difficult to believe that a candidate who can achieve scores of around 18 to 20 out of 25 in both questions 1 and 2 does not have the ability to pass; this happens all too frequently. In this paper a common theme of poor technique was wasting time. This is caused by number factors:

Giving an answer to a question that was not asked. Question 1 specifically stated that consolidated goodwill should NOT be calculated. Amazingly a significant number of candidates did calculate goodwill; it was often the very first thing they did.

Conversely, not answering a question that was asked. Question 4 required candidates to explain the predictive role of financial statements within the aspect of 'relevance' of the IASB's Framework. Many candidates wrote everything they knew about relevance (and reliability and the other qualitative characteristics) without any reference to a predictive role.

More minor aspects of technique were: unnecessary and very detailed workings, repetition and writing down the definitions of ratios which was not asked for. Some candidates who did this did not even calculate the ratios.

Other technique aspects were a lack of workings for some (complex) figures. Please be aware that markers cannot allocate any marks to an incorrect figure unless they can see how the figure has been arrived at.

Poor handwriting and an inability to clearly express oneself continue to be particular problem for discussion answers.

The composition and topics of the questions was such that on this diet there was very little difference between the International Paper (the primary paper) and all other variant papers, thus these comments generally apply to all streams.

Specific Comments

Question One

This required the preparation of a consolidated statement of comprehensive income in (a) (i) and the equity section of the statement of financial position in (a) (ii). This was followed by a short written section on the effect on goodwill (and its impairment) of the alternative ways of calculating non-controlling interests. Part (a) (i) included a fair value adjustment for a revaluation of the subsidiary's property, and eliminating intra-group sales together with unrealised profits on plant and inventory.

Pleasingly, the majority of candidates showed a good knowledge of consolidation techniques which led to many good scores. The main problem areas were:

Many candidates eliminated the cost ($30 million) of the intra-group sales from cost of sales; it should be the selling price ($40 million) that is eliminated as this is the 'cost' of the purchases to the subsidiary.
A failure to adjust (correctly) for the additional depreciation to the plant caused by it being transferred at a value above its cost and the unrealised profit on the transfer.

Although most candidates did calculate the non-controlling interest (NCI) in the profit for the year, few carried on this principle to calculate the NCI in the total comprehensive income. There was also some confusion between the principle of the NCI calculation in the income statement and in the statement of financial position (part of the equity in (a) (ii)).

A surprising number of candidates did not adjust for the share exchange when calculating the share capital and share premium (share capital only in SGP paper).

Very few candidates correctly calculated the 'other equity reserve'. In most cases candidates just added together the figures for this reserve at 1 April 2010 (the beginning of the year). This meant two errors; the pre-acquisition balance on the subsidiary's reserve should not appear at all in the consolidated reserve (it would be part of the goodwill calculation if it had been required) and the group's share of current year's movement in the reserve (as shown in the comprehensive income statement) was completely ignored. Similar errors were made in calculations for the land revaluation reserve.

As already mentioned, many candidates unnecessarily calculated consolidated goodwill, no marks were awarded for this as it was specifically stated as not being required. Also when calculating the NCI in the equity section of the statement of financial position, many candidates worked this by calculating the NCI's share of capital and reserves, often getting hopelessly lost. A much simpler method, as this was the year in which the controlling interest had been acquired, was to add the fair value of the NCI at the date of acquisition ($100 million as given in the question) to the NCI in the statement of comprehensive income (which should have already been calculated in (a)(i)).
Poorly prepared candidates failed to time apportion (for six months) the subsidiary's results and a lesser number proportionally consolidated (at 75%) the subsidiary's results.

The written section of part (b) was very disappointing. About half of the candidates gave no answer at all and of those that did, a lot missed point of the question. Instead of explaining the **effect** the two treatments (of valuing NCI) have on goodwill and its impairment, many candidates simply described what the two treatments were (rather than their effect). UK and IRL papers had an alternative section on the requirement to produce group financial statements which was generally well answered where attempted, but again it was often ignored.

Question Two
This question was a traditional preparation of financial statements (including a statement of changes in equity) from a trial balance, combined with several adjustments including: the issue of a convertible loan note, a revaluation of land and buildings, an inventory adjustment calculation, factored receivables and accounting for current and deferred taxation.

This was the best scoring question on the paper and attempted by nearly all candidates. Most candidates are well practised in knowing the format of the financial statements and as usual the problem areas were with the required adjustments. Even where candidates did not get all the adjustments fully correct, many marks were still earned for the method of their workings.

The frequent problems areas were:
Statement of comprehensive income

The question required an adjustment to the given value of closing inventory because it was counted several days after the year end. A number of candidates got the movement of these adjustments the wrong way round and reduced the year end inventory rather than increasing it. Surprisingly a lot of candidates adjusted the sales revenue for one of the inventory adjustments despite the question clearly indicating this was not necessary. Some candidates incorrectly stated that this was an event after the reporting date and so no adjustments were required
The administrative expenses required the reversal of a financing/administration costs of factored debtors because the risk of collection had not been transferred to the factor. Many candidates correctly recognised this, but failed to realise that they then had to recognise a receivables allowance (doubtful debt provision).

Many candidates had difficulty with the finance cost of the convertible loan, common errors were: using a discount rate of 8% instead of the effective rate of 10%, double counting the finance costs by adding the effective finance cost to the finance cost that had been paid or just taking the interest paid as the finance cost with no reference to the nature of the financial instrument.

The gain on the revaluation of the property to be included in other comprehensive income was generally well done (although many candidates just included the land element), however most candidates included the deferred tax on this gain as part of year's income tax expense rather than as part of other comprehensive income.

Statement of changes in equity (SOCIE)
When attempted this was generally very well done with many candidates gaining full marks. Where errors did occur they were mainly not including the equity component of the convertible loan and not adjusting the opening retained earnings for the dividend that had been paid during the year. As a point of reassurance, if a candidate makes an error in an earlier calculation (say of the dividend or the revaluation surplus) then they are not penalised again in the SOCIE; an incorrect figure will be marked as correct under the principle of "method marking" (or "own figure rule").

Statement of financial position (SOFP)
This was again generally well done with most errors being due to the knock-on effect of errors made in the statement of comprehensive income which were also not penalised under method marking, this particularly applied to non-current assets, inventory, receivables and the convertible loan note. There is still some confusion over the deferred and current tax figures that should appear in the SOFP. A very common error was not including the liability to the factor (Easyfinance) as a current liability and a careless, but common, error was the inclusion of the bank overdraft as a current asset.

Question Three
This question was an integrated statement of cash flows and interpretation question with candidates being directed to addressing an issue raised by a shareholder concerning an increase in revenue not being matched by an increase in profit.

As usual the statement of cash flows proved popular and was well answered by most candidates, the only recurring errors were: failure to take account of an asset held-for-sale when calculating the cash flow for non-current asset expenditure and, very frequently, omitting to calculate the dividend paid by investigating the movement of retained earnings.

Answers to the interpretation were more mixed. Five marks were available for calculating relevant ratios (which gives some measure of how many should have been calculated) and again many candidates scored well on these (often the maximum). The assessment of the performance of the company was less well answered. Weaker candidates did not attempt to explain why the revenue had gone up by 48% whereas profit for the year had increased by only 20%. Surprisingly, some candidates correctly calculated that the gross profit margin had increased (by 2%) and then said this partly explained the anomaly; obviously not realising that an increase in gross margin would have led to a proportionate increase in profit rather than the decrease actually reported. The operating margin was down very slightly, but did not account for the relative decline in profit. The real explanation of why the profit had decreased was due to higher finance costs (due to a new loan) and a much higher rate of taxation. Other aspects of performance were attempted reasonably well, many candidates observed the increase in tangible and intangible non-current assets suggesting acquisition/expansion and that this had been financed by additional borrowings which had increased gearing.

Comments on the current and quick ratios were common, but few recognised the impact that the non-current asset held-for-sale had on the liquidity. In this type of question many candidates become obsessed with calculating ratios for inventory, receivables and payables. In some cases these were the only ratios calculated although in this scenario they were not particularly important issues to support an answer to the question.

Overall many candidates did make intelligent comments about what the ratios they had calculated might indicate, however there were too many candidates who merely reported that a ratio had gone up or down, which does not amount to an assessment of performance.

Question Four

The introductory section (part (a)) of this question was related to the Framework's characteristic of 'relevance' and how the predictive role of financial statements enhances relevance. Candidates were asked to give examples of how the presentation of historical financial statements can assist users to assess future performance (the predictive role). The majority of candidates did not attempt this section and those that did had very little idea of what the question was about. Many of the answers gave the impression that the candidate thought it was a discussion of historical cost accounts (which is not the same as historical reporting). Also, most candidates missed the clue of part (b); simply mentioning the two examples in part (b) (discontinued operations and diluted EPS) would have gained two marks alone. Some other relevant disclosures would be:

Non-current assets held-for-sale (these will not generate future profits).

Separately disclosed material (sometimes called extraordinary) items; these are basically unusual often one-off or non-recurring gains or losses.

Comparative results; these establish past trends of performance which may be used to predict future performance.

Part (b)(i) Was a short section requiring candidates to estimate the next year's profit of a company based upon its current year's results which included discontinued operations. Most candidates scored well, the main mistake was not pro-rating the currents year's newly acquired operations (of 8 months) for a full year.

Part (b) (ii) required a diluted EPS calculation on continuing operations allowing for convertible loan stock and directors' share options for the current and comparative year. A surprisingly common mistake was for candidates to use the figures they had calculated in (b)(i), which were a prediction of 2012's earnings, as the basis of the EPS calculation of 2011. That aside, many good candidates did correctly allow for the interest adjustment (net of tax) for the convertibles and correctly calculated the number of shares on conversion. The treatment of the share options was less well understood; many just used the number of shares covered by the options, without reducing it by the number of shares that the proceeds of the option would theoretically buy, and very few weighted the option for the six months that it had been granted. Many candidates prepared a basic EPS calculation for both years and others got very confused in their determination to include the effects on EPS of a rights issue at below market price; neither were part of the question.

The most disappointing aspect of the question was the sheer number of candidates that did not attempt it (especially part (a)).

Question Five
This question focused on the regularly examined the area of construction contracts. It was a fairly standard question requiring candidates to produce extracts from the financial statements on the second year's progress of the contract; the first year's results were given in the question.

Candidates that gave this question serious attention scored quite well. In the income statement most calculated the total estimated profit and percentage of completion correctly, but did not take into account the previous year's results when reporting the current year's results, in other words they produced an accumulated income statement (for 2011 plus 2010). Many also tried to calculate a cost of sales when it should have simply been a balancing figure (of revenue less profit). Some candidates chose to calculate the percentage of completion based on a cost formula rather than work completed/contract price as specified in the question.

Common errors in the statement of financial position were not including amounts for the contact plant or contract receivables and then, in the note of the amounts due from customers, candidates often deducted the progress payments received rather than the progress billings.

Conclusion
Overall this was a disappointing performance after last diet's very good pass rate; however there was much to take heart from. There was a solid performance on questions 1 and 2 and a good understanding of cash flows. It seems to be the old problem of a lack of syllabus coverage that is preventing many marginal candidates from achieving a pass.

As usual, 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 and should not detract from the efforts of many candidates who performed well.