Chief Assessor's report

NVQ/SVQ Level 4 in Accounting

Diploma in Accounting (Diploma Pathway)

Drafting Financial Statements (Accounting Practice, Industry and Commerce) (DFS) 2003 Standards

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General comments

This was the fourth exam that assessed financial statements in accordance with international accounting standards (IAS), and it is very pleasing to note that, on the whole, candidates were very well prepared. It is a credit to their lecturers and to the publishers of textbooks and accounting manuals, as well as the efforts of students themselves, that the requirements of IAS were so well understood. Many candidates demonstrated high levels of competence across a range of tasks. Their performance was particularly strong in drafting financial statements in accordance with the requirements of IAS 1 and IAS 7. A grasp of the new terminology used in IAS caused little difficulty for the majority of candidates. Knowledge of the requirements of other accounting standards was more patchy and there is room for improvement here. Performance was stronger in computing and analysing ratios and in reporting conclusions than in some of the more recent exams.

Section 1

Task 1.1
This task required the drafting from scratch of journal entries from information provided in the question. Candidates coped reasonably well with this task.

Many candidates were able to deal with the missing sales. The accounting for the accrual and prepayment caused difficulty for some candidates. In particular, determining the amount of the prepayment was problematic for some. The accounting for inventories, taxation and interest payable was, in general, accurately recorded in the journal.

Overall, many candidates were able to achieve full marks in this task.

Task 1.2
The drafting of the company income statement and balance sheet was generally very well done. It was not uncommon for candidates to obtain full marks in this task. Surprisingly, a number of candidates who did not correctly adjust the journal entries in the previous task went on to make the appropriate entries in the financial statements. Candidates were given credit for carrying through incorrect entries to the financial statements, but a minority of candidates ignored their journal entries and made adjustments to the figures in the financial statements unsupported by journal entries. Sometimes the journal was correct but it was incorrectly implemented in the figures in the financial statements. A small minority of candidates ignored the balance on the income statement and did not add profit for the year to retained earnings in the balance sheet.

Task 1.3
This task involved preparing a consolidated balance sheet using the pro-forma in accordance with IAS 1. This task was, in general, very well done. It was pleasing to see that candidates, in the main, could cope with reporting not only individual balances but also the sub-totals of total assets, total liabilities and net current assets required in the pro-formas. A significant number obtained full marks in this task.

As was the case in previous exams, many candidates clearly demonstrated a grasp of the appropriate technique of consolidation and of the mechanics of calculating goodwill and the minority interest. However, those without a clear grasp of the point of consolidation or of the appropriate technique experienced difficulties with the task. Some weak candidates attempted proportional consolidation of assets and liabilities rather than using the parent company approach. Even some of the better candidates had problems with particular balances. Some included balances between the parent and the subsidiary undertaking in the consolidated balance sheet. The investment in the subsidiary was sometimes included as well, even where the goodwill and the minority interest had been correctly calculated. Both of these demonstrate a lack of grasp of the underlying concept of consolidation. A minority of candidates omitted to include the revaluation in their calculations.

Task 1.4
This task required the candidate to define a “business combination”; say how the acquirer in a business combination is identified; and state who was the acquirer in the circumstances set out in the task. The candidate needed to demonstrate a knowledge and understanding of the requirements of IFRS 3. Answers to this task were sometimes rather patchy. In general many candidates were aware that a business combination is a bringing together of separate entities into one reporting entity and that having the majority of shares with voting rights in another company was sufficient to establish the acquirer in such a combination. Only some candidates went on to talk about obtaining control of the other entity. Although some knowledge of the requirements of IFRS 3 was evident, this was sometime indicated in rather vague language that suggested only a superficial understanding of that accounting standard.
As usual, there is some evidence of ‘standards overload’, that is, the failure to adequately cover the assessable accounting standards.

Task 1.5
The drafting of a reconciliation of operating profit to net cash flows from operating activities was generally well done. The inclusion of income taxes and interest paid in the reconciliation did not provide any problem for most candidates. Some adopted the alternative method allowed by IAS 7 of including interest paid in the cash flow statement itself and were not penalised for this. Some candidates also included income taxes paid in the cash flow statement rather than in the computation of net cash from operating activities. IAS 7 makes it clear that this is not normally to be done unless there is clear evidence that the tax paid is attributable to investing or financing activities. Weaker candidates imported cash flows that are shown in the cash flow statement into the reconciliation. There was the occasional failure to use correct signs - addition or subtraction - for reconciling items.

Task 1.6
This task asked the student to prepare a cash flow statement using a pro-forma that follows the requirements of IAS 7. Most candidates did not have any problem in coping with the pro-forma required under IAS and many candidates obtained full marks on this task. Some candidates had problems in computing the capital expenditure during the year and the proceeds from the disposal of a fixed asset during the year, demonstrating the lack of a clear technique for calculating cash flows from these sources. Weaker candidates included balances from the financial statements rather than cash flows, which suggests that they did not quite grasp the point of the cash flow statement.

Section 2

Task 2.1

This task asked the candidate to identify the formulas used to compute ratios and to compute and analyse the ratios concerned. Candidates were also asked to give one suggestion for each ratio as to how performance relating to the ratio could be improved. This task was better answered than similar tasks concerning ratios in some of the recent exams. The ratios were profitability ratios and ratios concerned with the management of working capital and most candidates found these easier to calculate and comprehend. They were able to provide the correct formulas and to use them correctly in calculating the ratio. A relatively small number of candidates based the inventories turnover ratio on sales rather than cost of sales and a similar number of candidates based the trade receivables ratio on cost of sales rather than sales. A significant minority of candidates used the incorrect profit figure for the net profit ratio using profit before tax or profit after tax rather than profit before finance costs (interest) and tax (that is, profit from operations).

Most candidates correctly commented on the relative performance as indicated by the change in the ratios, stating whether the ratio has increased or decreased. The better candidate went on to indicate whether the change in the ratio meant that the ratio had improved or deteriorated and thus indicated a knowledge of the significance of the ratio change. However, some candidates indicated this through further comments on the performance of the company. It was pleasing that a significant number of candidates were able to give a plausible suggestion as to how the ratios could be improved.

Task 2.2

This task asked for the accounting equation and for a definition of the elements in the equation. This was generally well done. The accounting equation was accurately set out and it was pleasing to see that a significant number of candidates were able to give a reasonably accurate definition of the elements in accordance with the IASB's conceptual framework, the *Framework for the Preparation and Presentation of Financial Statements*. Some weaker candidates merely talked about assets as something owned by the entity or liabilities as something owed by the entity. These are only partial explanations of the elements and it is best practice to use the definitions set out in the IASB's conceptual framework. It is not necessary to learn these definitions by rote but the essence of the definitions should be grasped.

Many candidates explained how profit for the year increases the equity in the accounting equation, given that it is added to retained earnings that form part of the equity. Fewer candidates were able to explain how the net assets - that is, assets less liabilities – on the other side of the equation were affected by the increase in equity given that the increase in one side of the equation is matched by an increase in the other side.