Examiner's report

F7 Financial Reporting

December 2015

General Comments
This paper continued the format of recent diets having two sections and all questions were compulsory. Section A consisted of twenty 2-mark multiple-choice questions (MCQs) which covered a broad range of syllabus topics. Section B consisted of three questions (two for 15 marks and one for 30 marks). These questions covered the main syllabus areas of financial reporting, interpretation and analytical.

Overall, candidates' marks for both sections were well correlated. The numerical parts of the Section B questions were generally very well answered; however, as in past papers, the interpretation of ratios question was not very well answered with many candidates stating the obvious (e.g. this company's ratio is higher than the other company's ratio) without offering any real interpretation or analysis.

Specific comments

Section A

As might be expected, virtually all candidates attempted all the questions; as a last resort an educated guess is better than no answer. It is essential that candidates prepare for the F7 examination by working through the examples provided in the specimen papers and the materials provided by Approved Learning Partners. This and previous examiner's reports give examples of past MCQs that have caused particular difficulty for candidates. The commentary below is based on two such questions from the December 2015 exam and explains the correct answer and suggests why candidates may have selected a distracter (wrong answer). Section A questions are intended to examine across the syllabus and therefore candidates are required to have a broad F7 knowledge rather than just revising what are deemed to be the main syllabus areas.

Sample multiple-choice questions for discussion

Example 1
Ponto acquired 100% of the equity share capital of Sonto on 1 January 20X7. A fair value exercise conducted at this date identified two issues:

Issue 1 – Sonto owned the rights to a brand which it had developed internally. The fair value of the brand at 1 January 20X7 was reliably measured at $20,000.

Issue 2 – Sonto was defending a legal claim brought against it by a former employee. The fair value of the potential liability for damages payable was reliably measured at $85,000 on 1 January 20X7. Sonto's legal team had advised that there was only a 30% chance that they would lose the court case.

Both of these issues had been treated correctly in the separate financial statements of Sonto at 1 January 20X7. The purchase consideration paid by Ponto had already been agreed and will not be adjusted for the above issues.

What effect will these issues have on the calculation of the goodwill arising on the acquisition of Sonto in the consolidated financial statements of Ponto?

A Both issues will increase goodwill
B Both issues will decrease goodwill
C Issue 1 will increase goodwill and issue 2 will have no effect on goodwill
D Issue 1 will decrease goodwill and issue 2 will increase goodwill

Commentary
Once the purchase consideration for an acquisition has been agreed, then the recognition of an asset or an increase in the fair value of an asset will act to decrease the calculated goodwill figure (compared to the goodwill if no asset increase is recognised). This is because goodwill is equal to the purchase consideration less the fair value of the net assets at the date of acquisition The opposite of this is also true; where a liability is recognised as part of the fair value exercise, this will increase the calculated goodwill. Once this is understood, the question amounts to understanding whether issue 1 and 2 create assets or liabilities (or neither).

Most candidates would be aware that issue 1 creates a recognisable asset as the value of the brand can be measured reliably. The effect of this would be to decrease goodwill.

Issue 2 may have caused more problems. In the subsidiary's own financial statements this would correctly be treated as a contingent liability and disclosed in a note rather than be provided for. This is because the probability of a liability (losing the court case) is only 30%. However, on acquisition, where the fair value of a contingent liability of a subsidiary can be reliably measured, it should be recognised in the consolidated financial statements. On this basis issue 2 creates a liability on acquisition and would act to increase the calculated goodwill (the opposite of issue 1).

Answer D is therefore correct, however over 60% of candidates thought answer C was correct. This implies that they believed a reliably measurable contingent liability has the same treatment on consolidation as it does in the financial statements of the subsidiary. I suspect candidates answering A or B were simply guessing.

Example 2
During 20X4, Bloop incurred expenditure on two projects.

Project 1 costs relate to the initial design work on a new product which the company expects to develop for production over 20X5 and 20X6. At the beginning of the year, the company spent $2m on design equipment (which has an expected life of four years) and $1m on related salaries and materials.

Project 2 involves the testing of a new product which will be introduced to the market in 20X5 and is expected to generate profits over a four-year period. The company spent $4m on salaries and materials.

What is the total charge to profit or loss in 20X4 for the two projects in accordance with IFRS?

A $5·5m
B $3m
C $1·5m
D $1m

Commentary
This question tested an understanding of intangible assets relating to research and development. Project 1 is the initial design of a potential new product, at this stage the project does not meet the criteria for capitalisation and so related costs should be charged to profit or loss. The $2m spent on design equipment is a tangible non-current asset (property, plant and equipment), thus the depreciation ($0.5m = $2m/4 years) should be expensed, together with the related costs of $1m on salaries and materials ($1.5m in total).

Project 2 is at the testing stage of the development process, at which point any expenditure meets the criteria for capitalisation and therefore should not be expensed to profit or loss (until it is amortised when the product is introduced to the market in 20X5).

Answer C is therefore correct. The most common answer from candidates was A, which means those candidates thought both projects were at the research stage. Answer B was also quite popular, which implies that candidates had not treated the design equipment as property, plant and equipment and instead fully expensed it, whereas answer A (about 10% of answers) ignored or forgot to depreciate the plant.

Commentary on Section B

Question One

This was a 15 mark question requiring the calculation of consolidated goodwill (part (a) for 4 marks) and the preparation of a consolidated statement of profit or loss and other comprehensive income for 11 marks (part (b)). This question was generally well answered by candidates, with some gaining very high marks.

Part (a) contained many items that have been extensively examined in past papers; for the purchase consideration there was a share exchange, contingent consideration and non-controlling interest valued at fair value. The net assets acquired required an adjustment for the fair value of plant. The most common error was to include the contingent consideration at its value on the date the financial statements were being prepared (the year-end). It should have been at its original estimate with any change reported in profit or loss.

Part (b), the preparation of a consolidated statement of profit or loss and other comprehensive income, required time apportionment (nine months post-acquisition) for the acquisition of the subsidiary together with adjustments for unrealised profit (URP) in inventory and replacing the dividend income from an associate with the parent's share of its underlying profit (after tax). The other comprehensive income related to the revaluation of the group's property.

This was generally well done; however, the most common errors were:

- failure to time apportion some line items (commonly the associate's profit and additional depreciation on the plant)
- excluding all of the intra-group sales/purchases in the year (only post-acquisition intra-group items should be eliminated)
- using the wrong margin to calculate URP (and sometimes basing the URP on all intra-group sales, rather than on the inventory at the year-end)
- omitting the increase in the contingent consideration (following on from part (a))
- time apportioning the property revaluation gain of the subsidiary, even though the question clearly stated this gain was all post-acquisition
- failure to adjust the subsidiary's profit for the time apportionment, URP in inventory and additional depreciation, before calculating the non-controlling interest figures

Question Two

Part (a) was an 11 mark question based on assessing the relevant performance of two companies that were being considered for acquisition by a third company, followed by part (b) for 4 marks describing what further information would be useful when making an acquisition decision.

The information provided in the question for each company was (summarised) statements of profit or loss and financial position, together with nine selected ratios that had already been calculated. A minority of candidates recalculated or checked the given ratios which wasted their time.

On the whole, part (a) was poorly answered with many candidates gaining only 3 or 4 marks. The main problem, which has been commented on many times in previous examiner's reports, was that the majority of the interpretation consisted of repeating what the ratios were for each company and saying that one was higher than the other. A slight improvement on this was that sometimes candidates added that the higher ratio indicated a better performance.

A good answer to an interpretation question has to go deeper than this and suggest why one company's ratios may be higher (or better) than the other. To this end there was a lot of information (in addition to the ratios) provided in the financial statements. For example, one company had received a government grant which (unusually, but allowable) had been deducted from the carrying amount of the related asset. The relevance of this is that it would create a lower capital employed (and therefore a higher ROCE) than if the grant had been treated as, more usually, a deferred credit. Other important differences between the companies were: one company owned plant, the other mainly leased plant (and the owned plant it did have was nearing the end of its life, which too has important implications for the future). Also one company revalued its property (evidenced by a revaluation surplus in reserves) whilst the other did not, this might have had implications for security of borrowings. Both companies had $5m in loan notes, but one company's interest rate was 5% whilst the other was 10%, again worthy of questioning why this should be.

Answers discussing liquidity and gearing were a little better and gained appropriate marks.

Pleasingly answers to part (b) were much better and more incisive with several candidates gaining full marks for this part; however, calculating further specific accounting ratios in answer to this part earned no marks.

Question Three

This 30 mark question was set on the preparation of the financial statements of a single entity company from a trial balance with several adjustments. There were four parts: a statement profit or loss and other comprehensive income, a statement of changes in equity (SOCIE), a statement of financial position and some statement of cash flows extracts.
The adjustments required by the notes to the trial balance included, a property revaluation with related deferred tax, finance leases including a new lease at the beginning of the year to be incorporated with existing leases, a redemption of convertible loan notes (by a combination of cash and equity) including a new issue of equity shares to fund part of the redemption, and income and deferred tax provisions.
Most well-prepared candidates had a very good attempt at this question and generally scored good marks. The basic preparation and formatting of the statements seemed to be understood although some of the adjustments caused problems.

Common errors:

- some candidates had difficulty working out the remaining life of the revalued property, the original life was 20 years and the accumulated amortisation at the date of revaluation amounted to five years which meant the remaining life was 15 years.

- many candidates tried to separate the new finance lease from the existing leases in calculating both the amortisation charge and finance costs. For the latter, the question specifically said **not** to do this, and, indeed, there was insufficient information to be able do this. Rather inexplicably, a minority of candidates tried to calculate the lease finance costs and outstanding lease obligations (current and non-current) by starting with the opening carrying amount of the leased assets (rather than the opening lease obligation). Despite this, most candidates did seem to understand the principle of finance leases and gained appropriate credit even if one or two incorrect figures were used.

- some candidates did not separate the dividend paid from the loan interest paid, effectively treating the equity dividend as an expense rather than as a deduction from retained earnings.

- the issue of the equity shares used to partly fund the redemption of the convertible loan notes was generally correctly accounted for and reflected in the SOCIE; however, the actual conversion caused more problems, the most common of which was to only account for the nominal value of the conversion (ignoring the imputed premium) in the SOCIE.

- the taxation aspects were generally well done, but there were some problems with deferred tax. The deferred tax liability relating to the revaluation gain should have been shown in other comprehensive income (alongside the revaluation itself) and several candidates got some signing wrong, deducting items that should have been added. Also, on the statement of financial position, many included the opening balance (instead of the closing balance) for deferred tax and included the previous years under provision (settled by the year end) in the current tax liability at the year-end.

The last part of this question asked candidates to prepare the cash flows from financing activities as an extract from the statement of cash flows. This was similar (in principle) to part (e) of question 3 in June 2015 which was very poorly answered. It was pleasing to note that the answers for this paper were much improved, most candidates at least attempted it, but there were still several errors. The main problems were that most candidates could not work out the cash repayment of the finance lease which was the cash payments during the year less the amount attributable to (and reported as) finance costs. The redemption of the loan notes was either omitted or shown at the full amount (rather than the just the cash element).

Conclusion

Generally the performance was good, but with room for improvement, particularly on the MCQs. Candidates are reminded of the importance of working through the resources provided by Approved Learning Partners and reviewing F7 past papers to identify the skills required in applying their knowledge in the examination. An appropriate level of referenced workings are essential to allow markers to understand how answers have been arrived at - excessively lengthy or absent workings do not allow markers to do that. The F7 syllabus is extensive and good preparation of the whole syllabus is required as well as key technical skills such as analysis and interpretation. Well-developed examination techniques are also important to your success.