Examiner's report

F7 Financial Reporting
June 2015

ACCA

General Comments

Section A of this exam contains twenty 2 mark (40 marks in total) multiple choice questions (MCQs) whilst Section B comprises of two 15 mark questions and one 30 mark question. The performance on both sections was closely correlated.

The paper, particularly section B, was regarded by most commentators as a fair test of familiar topics on which a well-prepared candidate should have been successful.

Section A
The inclusion of MCQs allows each diet to cover most of the syllabus. This means that it is necessary for candidates to study the whole of the syllabus and not concentrate solely on what are perceived to be 'core' areas. The scores on individual MCQs varied considerably and the comments below relate to a number of questions that were not very well answered. The first two are examples of narrative questions, whereas the third example is computation based.

Example 1
Faithful representation is a fundamental characteristic of useful information within the IASB's *Conceptual framework for financial reporting*.

Which of the following accounting treatments correctly applies the principle of faithful representation?

A Reporting a transaction based on its legal status rather than its economic substance

B Excluding a subsidiary from consolidation because its activities are not compatible with those of the rest of the group

C Recording the whole of the net proceeds from the issue of a loan note which is potentially convertible to equity shares as debt (liability)

D Allocating part of the sales proceeds of a motor vehicle to interest received even though it was sold with 0% (interest free) finance

The correct answer to this question was **D**. The principle of the cost of finance has been examined at F7 several times and with this type of 0% interest product, the finance cost is built into the selling price. A similar principle would also apply to other 'offers' such as free maintenance or insurance.

Approximately half of candidates believed **C** to the correct answer. This is really surprising as the treatment of a convertible loan note which involves splitting the initial proceeds between debt and the value of the equity option has been examined often (and answered well). Perhaps many candidates did not read or think about the words 'whole of the proceeds' or 'convertible' properly.

Example 2
Which of the following statements relating to intangible assets is true?

A All intangible assets must be carried at amortised cost or at an impaired amount; they cannot be revalued upwards

B The development of a new process which is not expected to increase sales revenues may still be recognised as an intangible asset

C Expenditure on the prototype of a new engine cannot be classified as an intangible asset because the prototype has been assembled and has physical substance

D Impairment losses for a cash generating unit are first applied to goodwill and then to other intangible assets before being applied to tangible assets

The correct answer to this question was B. It seems most candidates assumed that, because the process would not generate additional sales revenues, it could not deliver future economic benefits (the core definition of an asset, intangible or otherwise). This is not the case, many development processes are intended to save costs, such as new cheaper and better materials or more efficient production methods. These too can deliver future economic benefits and so can be capitalised (subject to other criteria being favourable). The most frequent incorrect answer was D, followed by C. After applying impairment losses to goodwill, IFRS requirements do not differentiate between intangible and tangible assets, they are both written down pro rata (subject to other factors). With C, candidates did not seems to realise that it is the technology involved in the prototype that is the real asset (IAS 38 specifically indentifies technology as an intangible asset), not the physical components of it.

The poor performance on this question is perhaps due to an inability to apply knowledge to a given situation, rather than an issue of examination technique.

Example 3
19 Hindberg is a car retailer. On 1 April 2014, Hindberg sold a car to Latterly on the following terms:
The selling price of the car was $25,300. Latterly paid $12,650 (half of the cost) on 1 April 2014 and would pay the remaining $12,650 on 31 March 2016 (two years after the sale). Hindberg's cost of capital is 10% per annum.

What is the total amount which Hindberg should credit to profit or loss in respect of this transaction in the year
ended 31 March 2015?

A $23,105
B $23,000
C $20,909
D $24,150

The correct answer is D. At 31 March 2015 (one year after the initial sale), the deferred consideration of $12,650 would need to be discounted by 10% for one year to $11,500 (effectively deferring a finance cost of $1,150). The total amount credited to profit or loss would be $24,150 (12,650 + 11,500 or 25,300 - 1,150).

Over half of candidates arrived at **A** as their (incorrect) answer which discounted the finance for two years (but only one year remained at 31 March 2015). The other possible explanation of this error is that this figure of £23,105 **is** the sales revenue to be reported, but the question asked for the total amount credited to profit and loss (which must include the interest receivable for one year). Distracters **B** and **C** discount the whole of the proceeds (rather than half) for one year and two years respectively.

Section B

The questions in section B were generally well answered by well-prepared candidates.

Continuing the trend from the last diet, perhaps due to the new structure, most candidates attempted all the required questions in section B, however many candidates did not attempt sections (d) (EPS) and (e) (cash flow extracts) of question 3. There were other examples of poor examination technique, in particular, not reading the question requirement carefully and not planning the answer (including timing) properly.

Other familiar poor examination technique issues were: a lack of understandable workings for some figures and poor handwriting that many markers struggled to read.

Report on individual questions

Question One

This question was on consolidation. Part (a) required candidates to calculate consolidated goodwill and part (b) required extracts of the main line items of the consolidated statement of profit or loss. The question included the treatment of fair value of plant at acquisition, unrealised profit in inventory and goodwill impairment. Most candidates scored well on part (a), many gaining full marks. The two most common errors relating to the consideration were using the share price of the subsidiary where it should have been that of the parent, and failing to discount the deferred consideration (using $1.54 instead of $1.40).

A slightly unusual aspect of calculating the subsidiary's net assets at acquisition was that the pre-acquisition profits needed to be increased for an amount of borrowing cost (interest) that should have been capitalised under IFRS. This adjustment cause difficulty for many candidates (it was commonly ignored or deducted from pre-acquisition profits and/or not time apportioned), but other than this, most candidates were able to calculate the net assets at acquisition.

Part (b) required the calculation of consolidated revenue, cost of sales, finance costs and non-controlling interest in profit for the period. The revenue and cost of sales calculations were generally well done although occasionally candidates missed the impairment of goodwill or gave an incorrect additional depreciation calculation or incorrectly calculated the unrealised profit in inventory.

The most common error with the finance costs figure was not to include the unwinding of the deferred consideration, and sometimes for those that did account for this, they failed to time apportion the cost.

The capitalisation of the borrowing costs referred to in (a) also caused similar problems with this calculation.

Most candidates understood the principle of calculating the non-controlling interest, but often made errors with the adjustments for the impairment of goodwill, the additional depreciation and including the unrealised profit (although it was the parent that made the sale). A slightly worrying error was that some candidates started their calculation with the non-controlling interest used in the calculation of goodwill.

Many candidates prepared a full consolidated statement of profit or loss as well as the specific figures required which only wasted time and earned no additional marks.

Overall most candidates scored well on this question.

Question Two

This question was a traditional interpretation question; part (a) required the calculation of specified ratios and part (b) required a comparative analysis of the financial performance they revealed. The complication introduced in this question was that at the beginning of the current year (ended 31 March 2015) the company sold one of its divisions. The question gave four selected ratios for the year ended 31 March 2014 (which included the results of the division that had been sold) and then identified the division's separate profit or loss figures for that year.

Part (a)(i) required the recalculation of the given 2014 ratios after excluding the results of the sold division and (a)(ii) required the calculation of the equivalent ratios for the current year (2015). The purpose of this was that the ratios in (a)(i) and (a)(ii) would then be comparable.

The calculation of the ratios was disappointing, many candidates did not seem able to adjust properly for the effect of the sale of the division, in particular candidates failed to eliminate the carrying amount of the division when calculating the ROCE and net asset turnover for the adjusted ratios for 2014 (i.e. those for (a) (i)). Another common error was the failure to exclude the profit on the sale of the division when calculating the operating profit margin for 2015, despite the question requirement specifically stating this. Even some of the straightforward ratios, which are required knowledge at F3, were not calculated correctly and a significant number of candidates did not calculate the net asset turnover ratios at all.

The answers to part (b) were mixed; good answers correctly identified the effects of the disposal (overall a detrimental effect on the results and probably an unwise sale) and other important issues. Those answers that merely reiterated in words the movements in the calculated ratios did not score highly. For example, merely saying that the return on capital employed has increased by x% without giving the breakdown of the increase between profit margins and asset utilisation (the secondary ratios) or suggestions as to what may have caused the changes, is not interpretation. Many answers made no reference to the sale of the division at all and merely commented on the changes in the ratios.

Another poor exam technique included the calculation of many ratios that were not asked for (usually liquidity ratios) and then to discuss these in fine detail. It sometimes seems that candidates have prepared a specific approach to answering an interpretation question which they proceed to give, without focusing on what the question is actually asking for. Very few candidates commented on the lack of wisdom in paying such a large dividend and the effect of paying off half of the loan notes and the bank overdraft.

It should be understood that where candidates made errors in the calculation of the ratios in part (a) and assessed the comparative performance accordingly, markers were instructed to mark such interpretation as being correct (assuming it was), even though it may have been different to that in the published answers. This is a form of the 'own figure' marking principle.

Question Three
This was a traditional preparation of the financial statements for a single entity. The three main parts (a) to (c) were the usual preparation of statements of profit or loss, changes in equity and financial position. Part (d) was a 3 mark section on the calculation of basic earnings per share, involving the effects of a share issue at below market price and part (e) was short extracts from the statement of cash flows.

The question included notes requiring accounting for a rights issue of shares, redemption of loan notes, capitalisation of environmental costs, plant on both finance and operating leases, fair valuing and disposal of investments and the usual tax adjustments including deferred tax.
Most well-prepared candidates were expecting this type of question and scored very well on it, even if they weren't able to complete it. However, a significant number of candidates did not attempt the earnings per share and cash flow extracts of parts (d) and (e). Both of these topics have been examined many times, were not difficult, and thus represented a lost opportunity to gain some relatively easy marks.
The more common errors are detailed below:
Part (a) statement of profit or loss:

- Depreciation as part of cost of sales should have been straightforward (85 million × 20%), however many candidates separated two new acquisitions of plant (one under a finance lease) when the question clearly stated that these items were already included in property plant and equipment. A significant number of candidates applied reducing balance depreciation although the question clearly stated the straight line basis should be used. The other problem area within cost of sales was the incorrect treatment of the operating lease premium. Such premiums, payable at the beginning of the lease, should be spread over the lease term, in this case for four years. The deferred element of the premium is treated as an asset.
- Finance costs often excluded the second-half of the loan note interest (which was part of the suspense account), showed incorrect finance lease interest (some marks were given for incorrect figures here), and omitted the finance cost on the unwinding of the environmental provision.
- In the calculation of the investment income, candidates sometimes incorrectly deducted sales of $1.4 million from the investment's carrying amount before calculating the fair value gain at $1.9 million instead of the correct figure of $500,000 (the sale proceeds had already been deducted from the investment's carrying amount in the trial balance). A minority of candidates showed the gain (of $1.9 million or $500,000) as other comprehensive income when the question clearly stated the investments were at fair value through profit or loss.

- The most common mistake on taxation was to get either the adjustment for the previous year's overprovision or the movement on deferred tax the wrong way around although overall there was a marked improvement in the treatment of taxation items compared to recent diets.

Part (b) statement of changes in equity:
The only significant error in this section was that several candidates did not realise that the figures for share capital and share premium in the trial balance already included the 1 for 5 rights issue; thus they showed opening share capital of $30 million and calculated the rights issue at $6 million, whereas the correct answer was to work back from the closing share capital of $30 million to calculate the rights issue had been for 5 million $1 shares (with an equivalent effect on the share premium). 'Own figures' were marked as correct for the profit for the year but some candidates forgot to deduct the dividends paid. Some candidates showed the dividends received from the investments in this statement rather than in the statement of profit or loss and many candidates either showed the dividends paid as a deduction from profit after tax or (worse still) as a finance cost in the statement of profit or loss.

Part (c) statement of financial position:
As with questions of this type, many errors in the statement of financial position were the knock-on effects from previous calculations. Again under the 'own figure rule' such errors were marked as being correct assuming the correct principles had been followed.

This point particularly applied to non-current assets as nearly all errors here related to previous errors made in the calculation of profit or loss account items, the most common being depreciation charges and not correctly deferring the operating lease premium. Some candidates accrued six months interest on the loan notes whereas it had already been paid, but included in the suspense account.

Some candidates included the trial balance figure for deferred tax rather than the closing balance, this was usually because they had not calculated the movement on deferred tax.

Where candidates had not calculated a finance cost for the environmental provision, it was also omitted from the liability and often the environmental provision itself was completely omitted. Most candidates had a good attempt at dealing with the finance lease, the most common error was to treat the annual payment as occurring at the beginning rather than the end of the year. This is relatively minor error, and as long as the principles were still followed, such an answer attracted most of the marks available. Worryingly, some candidates treated the overdraft as cash in hand whilst some forgot to include the current tax payable in current liabilities.

Part (d) earnings per share:
As mentioned earlier, this part (and (e)) was often not answered at all. Of those that did answer it, many gained most, if not all, of the marks. Most of the errors related to an incorrect profit figure or using the incorrect amounts for share capital pre- and post- the rights issue, but, provided candidates were consistent with the use of the figures that they had calculated in parts (a) and part (b) for these figures, they were given the appropriate marks. Most of the marks lost on this section were mainly due to the incorrect calculation of the theoretical ex-rights value of the shares (or inverting the diluting effect of this calculation).

Part (e) extracts from the statement of cash flows:
Apart from where candidates did not give any answer for this section, there were other worrying errors. Several candidates did not seem to know the contents of investing and financing activities, instead these candidates often (tried to) reproduce the cash flows from operations or even a full statement of cash flows. By contrast, some candidates that did know the contents of the required sections, produced a 'pro forma' extract which contained no figures. This may have been in the mistaken belief that such an answer would attract some format marks, this is not the case; the marks available are for the figures. It is also possible in this situation that the candidates were running out of time, if this is so, it is better to give some of the figures for the cash flows (which will gain some marks) rather than the whole of a cash flow extract with no figures (this gains no marks).

As a point of examination technique, most of the figures required to answer this section were available either directly from the question (e.g. the cash price purchase of plant (item 1) and sale of investments) or from calculations made in answering the previous parts (e.g. the issue of shares, redemption of loan notes and equity dividends). Thus an answer should have been very quick to prepare. The only calculation necessary was for the repayment of the finance lease which required the deduction of the interest charge from the total of the deposit and the first annual payment of the lease. Again the marks in this section would have been given for 'own figures'.

Conclusion

Overall many candidates appeared not to have progressed their knowledge sufficiently beyond F3. There also seemed to be a lot of poor examination technique, perhaps caused by not spending enough time practicing past questions and/or spending too much time on Section A.

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. There were also many excellent scripts that were rewarded appropriately.