Examiner's report
F7 Performance Management
June 2016

General Comments
The June 2016 paper represented the final paper in the current format. There were two sections; Section A consisted of 20, 2-mark multiple-choice questions (MCQs) which covered a broad range of syllabus topics, Section B consisted of three questions (two questions for 15 marks and one for 30 marks). These questions covered the main syllabus areas of consolidated financial statements (extracts), ratio calculation and analysis and the preparation of single entity's financial statements. All questions on the paper were compulsory.

The results for both sections were well correlated, although most candidates scored slightly better in Section A than in Section B. The numerical parts of the Section B questions were generally very well answered; however, as in past papers, the interpretation question was not as well answered with many candidates stating the obvious (e.g. this year's ratio is higher than the previous year's) without offering any real interpretation or analysis and largely ignoring the effect of a very important discontinued operation.

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 at all. As these questions are auto-marked, it is difficult to know exactly what type of errors candidates make but candidates preparing for the F7 examination are advised to work through the specimen paper and available past exam papers. This examiner's report provides examples of MCQs that have proved difficult for candidates. The commentary below on two selected poorly-answered MCQs goes through the correct answer and suggestions of why candidates may have selected a distracter (wrong answer). Section A questions are intended to examine the syllabus broadly and so candidates need to be competent in all areas of the F7 syllabus, rather than rely on trying to pass by just revising bits of the syllabus.

Sample multiple-choice questions for discussion

Example 1
Which of the following are required to meet the comparability characteristic of useful financial information?

(1) Entities are required to disclose their accounting policies
(2) Corresponding information is required to be provided in financial statements
(3) Entities must use the same accounting policies from period to period
(4) All assets within a class should be depreciated at the same rate

A 1 and 2 (correct)
B 2 and 3
C 3 and 4
D 1 and 4

Commentary
If candidates understand what accounting concepts mean then this should have been a relatively straight forward question . However, it seems a number of candidates simply **learn** the accounting concepts (in the IASB Framework) are, without actually understanding them or being able to apply them.

The concept of comparability, rather similar to consistency, can be applied in two circumstances. First there is internal comparability where an entity's current year results are compared with its past (at least one year) results. However, comparability can also be extended to the comparison of one entity's results to that of another entity's results (for entities of a similar size, in a similar industry sector and for the same accounting period).

Item (1) assists in the second form of the comparability in that it recognises that not all entities use the same accounting policies (not that they should). In these circumstances the disclosure of accounting policies allows users to identify when the financial statements of entities differ because they have used different accounting policies. From this information, users may be able to make notional adjustments (if appropriate) to achieve a form of comparability when assessing relative performance.

Item (2) is self-evident; to compare current year performance to past performance, users need to be provided with past (comparative) results.

The statement in Item (3) is incorrect; entities are permitted to change their accounting policies, the reporting requirements of which are determined by IAS 8 *Accounting policies, changes in Accounting Estimates and Errors*. Also, if it were applied, this statement would not provide comparability but rather uniformity. It is widely recognised that uniformity is not necessarily the same as comparability because different accounting policies are appropriate to entities that have different operating conditions.

Item (4) is a sub-form of item (3). Assets should be depreciated over their estimated useful lives (straight-line or reducing balance as appropriate) and clearly different assets, even of the same class, have different lives (and perhaps also different usage patterns).

From this, items (1) and (2) are relevant to comparability and items (3) and (4) are not; thus **A** is the correct answer.

Example 2
Blue Co entered into a four-year lease agreement on 1 January 20X0. It required payments of $19,000 to be made annually in arrears. The asset had an estimated economic life of four years and a fair value of $60,000 with nil residual value. The interest rate implicit in the lease is 10%. Blue has incorrectly treated the lease agreement as an operating lease in its financial statements.

What is the effect of the incorrect treatment on Blue Co's profit for the year ended 31 December 20X0?

A Overstated by $2,000 (correct)
B Understated by $2,000

C Overstated by $13,000
D Understated by $13,000

Commentary
This question tested an understanding of the effect on profit or loss of treating a lease as an operating lease as opposed to a finance lease. To compute the correct answer, it is necessary to calculate the charges to profit or loss for depreciation and finance costs that would be reported from treating the lease as a finance lease and comparing those charges with the charge that had been made by treating the lease as an operating lease (the annual rental of $19,000). With the lease capitalised at $60,000 and a life of four years this would give an annual depreciation charge of $15,000. As the annual rental was payable in arrears there would be a finance charge of $6,000 ($60,000 x 10%). This would give total charges to profit or loss of $21,000, the difference between this and the $19,000 operating lease rental charge would require an additional charge of $2,000. Thus, incorrectly treating the lease as an operating lease would mean the profit for the year was overstated (as expenses were understated) by $2,000 – answer **A.**

Many candidates calculated the difference as $13,000, presumably comparing the operating rental of $19,000 with the finance cost of $6,000 thus ignoring the depreciation. Of the candidates that correctly calculated the difference as $2,000, a significant number thought the effect was an understatement rather than an overstatement of profit.

Commentary on Section B

Question One
This was a 15 mark question requiring the calculation of extracts from the consolidated statement of financial position for goodwill, retained earnings and non-controlling interest. Pleasingly this question was very well answered and some candidates gained full marks.

However, a word of caution – a number of candidates produced a full consolidated statement of financial position which was not asked for and so merely wasted time.

The calculation of goodwill involved dealing with a share exchange, deferred consideration and fair value adjustments. Most candidates correctly calculated the consideration for the acquisition; the main problems were in calculating the net assets at the date of acquisition. A common error was not time apportioning the $3,000 loss for the year and many candidates treated this as profit. Another common error was to either ignore, or not realise, that the unrecorded deferred tax in the subsidiary's financial statements should be recognised as an asset on consolidation (due to the circumstances described in the question).

Many candidates scored well in the calculation of retained earnings, however some had difficulty calculating the post-acquisition profits of the subsidiary. In particular they did not account for a loss on equity investments or adjust for the over-depreciation on the fair value (which was **below** the carrying amount of the plant in the subsidiary's financial statements); many candidates seemed to think the plant was under-depreciated. Other common omissions were: incorrect deductions of the unrealised profit in inventory (especially using margin rather than mark-up) and ignoring (or not time apportioning) the unwinding of the finance cost on the deferred consideration.

Most candidates gained full marks for the calculation of non-controlling interest even if they had made a previous error in the calculation of the subsidiary's post-acquisition profits. It is important that candidates realise that errors in previous calculations are not penalised in subsequent calculations. This principle is referred to as method marking or applying the 'own-figure' rule.

Question Two

Part (a) was a short 3 mark section requiring the calculation of the ROCE based upon continuing operations. Part (b) for 12 marks required the calculation of four further ratios of the candidates' choice to form the basis for an analysis of the performance and financial position of an entity over a two-year period.

Very few candidates correctly calculated the ROCE in part (a); by far the most common error was a failure to deduct the value of the assets held for sale (relating to the discontinued operation) from the denominator representing the capital employed. The other, less common, error was not adding back the finance costs to give profit before interest and taxation. Despite this, most candidates gained two out of the three marks available.

In part (b) many candidates scored well for calculating up to four further ratios but some candidates only calculated ratios for various profit margins (or cost percentages) and therefore ignored ratios relating to the financial position. By contrast, the interpretation and analysis was disappointing and many candidates merely described the ratios as being higher or lower without any explanation or implications which is not really interpretation. An important aspect of the comparison between the two years was the effect of the decision to discontinue an operation. Where this occurs, the figures and the ratios for the continuing operation are more important as it is these that form the basis of future performance. Many candidates did not adopt such an approach. Ancillary to this was whether the discontinuance itself was a good decision. In this case, as the discontinued operation had gone from being profitable to making a considerable loss, the decision to terminate the activities was well advised. Worryingly, some candidates that did comment on the discontinuation, thought the opposite. In a previous examination question there had been a disposal of a very profitable operation which appeared to be a poor decision and it looked as if some candidates had 'memorised' the suggested solution and applied it incorrectly to what was a very different situation.

Despite this, there were many good comments on the gearing and liquidity position which gained appropriate marks.

Question Three

This 30 mark question was on the familiar and seemingly popular topic of the preparation of the financial statements of a single entity from a trial balance with several adjustments. There were four parts: a statement profit or loss and other comprehensive income (a), a statement of changes in equity (b) a statement of financial position (c), which was followed by part (d) for 5 marks that tested an understanding of the meaning and usefulness of diluted earnings per share figures.

The adjustments required by the notes to the trial balance included: the treatment of a discount on revenue for combining servicing costs with a product sale, a (construction) contract, the issue of a convertible loan note, the upward revaluation of land and buildings and current and deferred tax adjustments.

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, perhaps as expected, it was some of the adjustments that caused most problems.

Common errors:
IFRS 15 *Revenue from contracts with customers* outlines the required treatment where a discount is given if products are sold in combination with an accompanying discount. Broadly, the discount is applied in proportion to the underlying value of the product and, in this case, the servicing. In addition to dealing with this, candidates needed to realise that three years of future servicing work should be treated as deferred income. Many candidates seem to appreciate the principles involved (for which marks were given) but made various errors in the calculations.

Many candidates correctly calculated (in the workings) the correct figures for the contract; however a common error was then not to include contract revenue and costs in the statement of profit or loss or the contract balance in the statement of financial position. Some candidates incorrectly calculated the percentage completion of the contract by comparing the payment received to the total contract price. The question clearly stated the progress towards completion should be based upon the input method (ie costs incurred to date in comparison to total expected costs).

Most candidates did very well dealing with the revaluation of land and buildings and the subsequent depreciation of buildings. The depreciation/amortisation and carrying amounts of plant and the patent were generally well done. The patent had suffered an impairment and many candidates effectively combined the amortisation and impairment charges, whereas strictly they should be identified separately. The question said that the entity intends to make an annual transfer from the revaluation surplus to retained earnings, many candidates omitted this from the statement of changes in equity; others transferred the full amount of the revaluation surplus rather than the additional depreciation for the year.

The treatment of the convertible loan note was mixed; some candidates have mastered the process of separating the compound financial instrument into its debt and equity components (though many omitted the equity component from the statement of changes in equity). However, many others became confused and produced calculations that looked more like the treatment of a finance lease. Finance cost charges in profit or loss should have been based on the effective interest rate of 8% applied to the debt component of the loan, some candidates used 5% on the nominal amount of the loan; the interest paid (on the nominal amount) reduces the carrying amount of the liability and is not a finance cost.

Some of the adjustments required should be very familiar; for example, the calculation of a provision for income tax, an adjustment from the previous year and a change in deferred tax have all been examined many times. Many candidates did well when calculating the profit or loss charge and the balances to be included in the statement of financial position. However there was some confusion over signing (adding items when they should have been deducted) and exactly which figures should appear as current and non-current liabilities.

Part (d) required candidates to appreciate that the convertible loan notes gave rise to a dilution of earnings per share (EPS), and indeed many candidates did say this. A second aspect of the question was that the chief executive officer (CEO) had expressed concern over the (given) diluted EPS figure and implied that the CEO thought that the diluted EPS figure was a representation of what the actual EPS would be in the near future. Candidates were asked to comment on the CEO's views.

Many answers did not address this issue at all and many of those that did were rather confused in that they agreed with the CEO's view but did not realise that diluted EPS is not a prediction of future EPS. The diluted EPS represents a computation of what EPS would have been for the current year if the diluting circumstances had already taken place (in this case the conversion of the loan notes). Many commentators see the diluted EPS as a warning; however the future earnings per share will be based upon future profits and the weighted number of shares in issue at that time.

Conclusion

The F7 syllabus is extensive and good preparation of the whole syllabus is required. Generally the performance in June 2016 was very encouraging, particularly in the MCQs in Section A. In section B, candidates are reminded that analytical and interpretive skills are key, as is an appropriate level of referenced workings which allow markers to understand how answers have been derived. Future F7 candidates are advised to use the Practice and Revision kits of the Approved Content Providers to aid their revision and to review F7 past papers to identify the skills required in applying their knowledge in the examination.