Examiner's report
F7 Financial Reporting
December 2016

Introduction

Performance at the December 2016 diet was good and there were some excellent individual performances.

Overall, candidates were well prepared for this examination in financial reporting, which was pleasing to see.

General Paper Comments

The examination consisted of three sections.

Section A contained 15 objective testing questions of 2 marks each, for a total of 30 marks, Section B contained three scenarios consisting of 15 objective testing questions of 2 marks each, for a total of 30 marks and Section C contained two questions of 20 marks each, for a total of 40 marks.

Candidates need to have knowledge of the entire syllabus and will not be successful if they simply rely on 'question spotting' a few selected areas for study. This is especially important given the format of the examination outlined above. To pass F7, students must have a good all-round knowledge of financial reporting, rather than attempting to focus on what students may perceive to be 'major' areas of the syllabus.

The paper was a fair test of familiar topics, and well prepared students would have been able to score well.

The most pleasing thing regarding the results showed that there were similar levels of performance across all three sections, highlighting that students are studying the wider syllabus well rather than focusing on the areas covered in section C.

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Section A (questions 1-15)

It was very pleasing to see that almost all candidates attempted all of the questions, suggesting that students were able to manage time well and at least provide an attempt at an answer rather than leaving an item blank.

The following questions are reviewed as they relate to items which candidates found particularly difficult. Example 1 is a narrative question showing the importance of understanding ratios rather than being able to just calculate them. Example 2 included an element of calculation, but was testing the knowledge of how a revaluation surplus is constructed for a consolidated statement of financial position.

Example 1

Fifer Co has a current ratio of 1·2:1 which is below the industry average. Fifer Co wants to increase its current ratio by the year end.

Which of the following actions, taken before the year end, would lead to an increase in the current ratio?

A Return some inventory which had been purchased for cash and obtain a full refund on the cost
B Make a bulk purchase of inventory for cash to obtain a large discount
C Make an early payment to suppliers, even though the amount is not due
D Offer early payment discounts in order to collect receivables more quickly

This question tested the understanding of the current ratio. The lack of numbers in the question was deliberate as it meant that candidates were required to think of how the ratio was constructed and the way in which transactions can influence it.

The correct answer was C. This would cause an equivalent decrease in both current assets and liabilities, so numerous candidates discounted this thinking it would therefore have no impact on the ratio. By applying simple figures to this, candidates could have seen that it had decreased. For example, if current assets were $120,000 and current liabilities were $100,000, this would give the original current ratio of 1.2:1. If an entity paid $20,000 to suppliers, this would make current assets $100,000 and current liabilities $80,000, giving a current ratio of 1.25:1.

Many candidates opted for B here, thinking that the discount would affect things. This would lead to an increase in inventory but equivalent decrease in cash, meaning that current assets (and therefore the current ratio) was unchanged.

Option A would cause an equivalent movement in inventory and cash, again leaving current assets unchanged.

Option D would actually cause a decrease in the current ratio, as the receivables would decrease more than the cash would increase due to the discount being offered.

Example 2

On 1 October 20X8, Picture Co acquired 60% shares in Frame Co. At 1 April 20X8, the credit balances on the revaluation surpluses relating to Picture Co and Frame Co's equity financial asset investments stood at $6,400 and $4,400 respectively.

The following extract was taken from the financial statements for the year ended 31 March 20X9:

	Picture Co	Frame Co
	$	$
Other comprehensive income: loss on fair value of equity financial investments	(1,400)	(800)

Assume the losses accrued evenly throughout the year.

What is the amount of the revaluation surplus in the consolidated statement of financial position of Picture Co as at 31 March 20X9?

A $4,520
B $4,760
C $5,240
D $9,160

This question was testing the knowledge that a consolidated statement of financial position's revaluation surplus consists of 100% of the parent's revaluation surplus and the parent's share of the post-acquisition revaluation surplus of the subsidiary.

The correct answer was A. This took the parent's revaluation surplus at year-end of $5,000 (being the $6,400 less the $1,400 loss in the year) and then took the subsidiary's post-acquisition loss of $400 (being the $800 time-apportioned for 6 months) multiplied by the parent's percentage of 60% to give $5,000 - $240 = $4,760.

A high number of candidates opted for C, showing they understood the principle but had added the $240 rather than deducting. This highlights the importance of reading the question carefully as these candidates knew the rule but had been unable to spot that the post-acquisition movement was a loss.

The candidates opting for A had also missed some information. In this case they had deducted a full year's loss, rather than time apportioning it to reflect the post-acquisition loss.

Any candidate selecting D had added the total revaluation surplus of both companies together, before adjusting for the post-acquisition movement.

Section B (questions 16-30)

Each of the three Section B scenarios is followed by five objective testing questions which, whilst based upon the scenario, can come from any area of the syllabus. As with Section A, future candidates should aim to revise all areas of the F7 syllabus, rather than attempting to question spot.

The first of the three questions focused on the area of non-current assets and was easily the best answered of the three questions in section B.

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The second scenario looked at events after the reporting period and non-current assets held for sale. Students could identify non-adjusting events well but were less able to obtain marks in relation to the non-current assets held for sale. One of the questions required the statement of profit or loss charge in relation to the asset. This needed the inclusion of depreciation and an impairment. Many students calculated the depreciation but not the impairment, meaning that the statement of profit or loss charge was understated.

The third scenario related to financial instruments. Calculations involving a convertible instrument were done particularly well, but students scored lower on the definitions of equity and identifying the correct treatment for financial assets. This highlights the need for students to understand definitions and theories as well as being able to produce accurate calculations.

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Section C (questions 31-32)

Question 31

This was a consolidation question in two parts. Part (a) asked for a calculation of goodwill, whereas part (b) required the completion of a consolidated statement of profit or loss.

This question was generally very well answered, with many students able to score maximum marks on the goodwill particularly.

In part (a), the candidates were faced with a share exchange and deferred consideration, both of which were calculated well generally.

The students were also able to deal well with a fair value adjustment to plant at acquisition. A significant minority of students deducted the fair value depreciation from the asset at acquisition, when this should only be applied to the post acquisition period.

One of the more unusual adjustments involved a fair value adjustment to inventory. This required an adjustment being made to increase the net assets at acquisition. As the inventory had been sold by the year end, this meant that the cost of sales also needed to be increased to reflect the increased value of the inventory sold in the post-acquisition period.

Candidates found part (b) more challenging in general, but were still able to score well on average. Students who failed to spot that the acquisition of the subsidiary was partway through the year were unable to obtain any marks for consolidating the subsidiary for 9 months of the year. This is a common scenario within a consolidated statement of profit or loss and one which students should continue to be aware of.

The question also contained a number of common adjustments to consolidated statements of profit or loss, including fair value adjustments, intra-group sales and unrealised profits. The calculations surrounding the fair value depreciation and unrealised profits were done well, showing that candidates are well able to produce these key adjustments.

Common areas where students did not pick up marks included intra-group sales. A disappointing number of candidates were unable to remove the full amount of the intra-group sale from cost of sales, therefore meaning that the cost of sales calculation was inaccurate.

The biggest single issue within the question was the missing calculation surrounding the non-controlling interest. Several students omitted this calculation completely, meaning that they failed to obtain any marks for this. The calculation of the profit attributable to the non-controlling interest is a key part of the construction of a consolidated statement of profit or loss and students must ensure they provide this calculation.

Question 32

This longer-form question comprised three parts, totalling 20 marks.

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Part (a) involved the restatement of figures relating to a target company, to provide equivalent figures once benefits gained from trade with a competitor company were lost. Calculations in this part were done well, but a common mistake was to exclude a revaluation gain from equity, meaning that candidates did not gain these marks.

Part (b) then required the recalculation of ratios. This section was answered excellently, with many students scoring full marks. The major issues around the ratio calculations involved the use of the restated figures, which the candidates needed to use from part (a). A small minority of candidates attempted to restate the figures in part (a) but then ignored those figures in part (b), simply using the figures given in the question.

Part (c) involved a discussion of the performance and gearing of a company targeted for acquisition. As in previous sittings too many candidates either omitted this section or simply provided answers explaining that decreases in the ratios represented a decline. Commentary focusing solely on this will only ever score limited marks, as it can be rote-learned and is not at all focused on the scenario in the question.

The highest scoring candidates were able to utilise the scenario and discuss its effect on the performance and gearing of the target company. The information in the scenario referred to the loss of the use of a brand name, the reduction in a licence fee payable and the loss of a discount. In addition to this, loan notes were replaced with higher-interest loan notes. To score well, candidates needed to discuss the impact of the lack of brand name on the revenue, and the impact of the discounts on the gross margin and return on capital employed.

The candidates who provided discussions along this line were following the ‘because’ principle, looking to provide reasons for any improvements or declines in ratios rather than simply stating that the ratio had improved or deteriorated. This is the analysis that is hoped for in these questions, and students must attempt to use the information given in the scenario to inform their answers.