Examiner's report

F7 Financial Reporting
March 2016

General Comments

This paper continued the format of recent diets with two sections; all questions were compulsory. Section A consisted of twenty 2-mark multiple-choice questions (40 marks) (MCQs) which covered a broad range of the syllabus. Section B consisted of three questions (two for 15 marks and one for 30 marks - 60 marks) and was expert marked. Section B questions tested financial statement preparation and interpretation skills.

The overall pass levels for both sections of the paper were well correlated and overall, the performance was very pleasing. The numerical parts of the Section B questions were generally well answered although, as on previous occasions, the interpretation question was not well answered. The short written element of the consolidation question was either not attempted or, for the few attempts seen, not answered that well.

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

Specific comments

Section A

As might be expected, virtually all candidates attempted all the questions; an educated guess is better than no answer at all. As these questions are automatically marked it is difficult to know what sort of errors candidates made. These questions allow each diet to cover most of the syllabus which means candidates cannot rely on trying to pass just by studying the main syllabus areas. The continuing advice is for candidates to work through the practice and revision kits provided by approved content providers and the exam papers made available on the ACCA website (including the specimen exam).

This and previous Examiner's Reports give examples of MCQs that have caused particular difficulty for candidates. The commentary below, on two poorly-answered questions from the March 2016 paper, goes through both the correct answer and suggests why candidates may have selected a distracter (an incorrect answer).

Sample multiple-choice questions for discussion

Example 1

Pink Co is a company which is not part of a group. It has the following intangible assets:

(1) A licence to distribute a particular product. This was purchased on 1 January 20X3 for $100,000 and is for 5 years.
(2) The right to use a trademark on its products for 10 years for which Pink Co paid $40,000 on 1 January 20X4. Pink Co also spent $30,000 on the same date constructing a concrete representation of the trademark for display at its premises which is expected to last for 15 years.

(3) A customer list which has been independently valued at $15,000 at 31 December 20X4. Pink Co is negotiating with several companies interested in buying the customer list.

What carrying amount should appear in Pink Co's statement of financial position for intangible assets as at 31 December 20X4?

A $96,000
B $124,000
C $111,000
D $139,000

Commentary

This question tested candidates' knowledge of the initial measurement and subsequent recognition of intangible assets. The correct answer was **A ($96,000)**: (1) the licence is recognised at cost less two year's amortisation ($100,000 - $40,000 [100,000/5 x 2] = $60,000; (2) the trademark is recognised at cost less one year's amortisation ($40,000 - 4,000 [40,000/10] = $36,000. The concrete replica would be separately recognised as a part of property, plant and equipment (tangible assets) and the customer list would not be recognised as an asset as it is not possible to distinguish this from the costs of developing the business as a whole and, at the reporting date, there is no transaction to say it is probable the expected future economic benefit (of $15,000) will flow to Pink Co. Distracter B incorrectly includes the concrete representation at cost less one year's depreciation ($30,000 - $2,000 [30,000/15] = $28,000); distracter C incorrectly includes the customer list at $15,000 and distracter D incorrectly includes both the concrete representation and the customer list.

Example 2

On 1 August 20X4, Flash Co received a $12 million training grant from the government on condition that it employed ten graduates from local universities in each of the next three years. If the condition were to be broken, the full amount of the grant would be repayable. On the date the grant was received it was considered virtually certain that the condition would be met.

However, during August 20X6, it became apparent that the economy was entering a severe recession. In that month Flash Co decided it would not employ any further graduates for the foreseeable future.

By how much will Flash Co's profit for the year ended 31 July 20X7 be reduced as a result of the repayment of the grant?

A It would not be reduced
B $4 million
C $8 million
D $12 million

Commentary

This question tested the accounting treatment of a government grant over a number of periods and applying the specified condition attached to its possible repayment. The correct answer was **C ($8 million)**: the company's statement of profit or loss had been credited with $4 million ($12 million/3 years) in the year ended 31 July 20X5 and with a further $4 million in the year ended 31 July 20X6. Given the change in circumstances, these two amounts should be reversed (i.e. debited) so profit for the year ended 31 July 20X7 would fall by this amount. Distracter A ignores that any grant has been credited to profit or loss that now needs to be reversed; distracter B only takes account of one year's adjustment; distracter D (the most common answer) assumes that all of the grant had already been credited to profit or loss although the year stated in the question is the final year, but no adjustment for the grant has been made.

Commentary on Section B

Question 1

This was a 15 mark question requiring the calculation of a company's revised profit for the year and the statement of financial position, including adjustments for: a share issue at a premium, dividend, property revaluation, development expenditure, an inventory write off and taxation adjustments. The question was generally well answered with many candidates gaining high marks.

In part (a), a large number of candidates were either not prepared to, or simply didn't know how to, prepare a schedule of adjustments. This particular approach has been examined before (e.g. December 2014, question 2, Kandy). The starting point should be the draft profit before tax given in the trial balance followed by a series of relevant additions (or subtractions) to arrive at a figure of profit for the year. Many candidates prepared a series of unrelated (and often correct) workings, but did not attempt to summarise these or even state their effect on the statement of profit or loss. The requirement for a schedule is an alternative approach to the preparation of a full statement of profit or loss, but one which still tests key principles of profit measurement.

Common errors were: not adjusting the amortisation on the leased property to take account that it had been revalued at the start of the year and that a number of years of its life had already passed, so subsequent amortisation was over a reduced period; using the straight line (rather than reducing balance) method of depreciation for plant and equipment; not writing off the early month's development expenditure and then correctly amortising the remaining asset; incorrectly calculating the net realisable value of the inventory and subsequently writing off the difference between this amount and the cost; including the revaluation of the property (which is other comprehensive income), with or without the related deferred tax, as part of the calculation of profit for the year. Many weak answers also deducted the dividend paid, although this is not an expense under IFRS.

Part (b) required the statement of financial position incorporating figures in the given trial balance and the adjustments from part (a). Provided clear workings were shown, markers awarded the allocated marks in part (b) for following through candidate's figures from part (a) under the "own figure rule" used during marking. As such, the common errors noted in part (b) were both the errors followed though from part (a) and specifically: showing the bank balance as an asset (it was a credit balance in the trial balance); only showing the original value or the amount of the write off for inventory; ignoring the revaluation of the property or (more commonly) not adjusting the surplus for deferred tax; incorrectly splitting the share premium from the share capital (or showing the premium element under both amounts). A number of candidates prepared a full statement of changes in equity as part of their answer, although this was not required by the question (and so wasted time).

Question 2

Part (a) of this question required candidates to calculate six equivalent ratios to the sector averages. The question specifically stated the treatment of the finance lease obligations in the ratio calculations. Many candidates scored full marks and showed appropriate workings to support the ratios.

A surprising number of candidates either avoided or incorrectly calculated asset turnover (a very common error was calculating net assets/turnover which is the inverse of the correct calculation); Candidates also incorrectly excluded the current liability finance lease obligation from capital employed and gearing. In differing combinations, weaker scripts: took profit before tax as operating profit for the operating profit margin; excluded the non-current liability finance lease obligation from capital employed and gearing; included the other current liabilities in these ratios; calculated gearing as debt/capital employed although this question specifically stated debt/equity.

Part (b) of this question was generally poorly answered - many candidates merely stated a particular ratio was higher or lower than the sector average, often without even stating whether this meant the company's financial performance or position was better or worse than that of the sector. Few candidates displayed any ability to connect the ratios and discuss causes or implications arising from them. An example is that the ROCE of the company was much lower than the sector average, but an analysis of this would reveal that the main cause of this was the lower gross profit margin, which may be due to a combination of lower selling prices and higher manufacturing costs. Many candidates stated that the poorer operating margin was a consequence of the high level of finance costs, although these should be excluded from the operating margin. Candidates also commented that high operating costs caused the lower operating profit margin whereas, in fact, the company's operating costs were a lower proportion of revenue than for the sector. Beyond stating that gearing was much higher than the sector, better scripts linked this to the high level of finance costs and the significance of the finance leases to the company.

Particularly weak scripts commented as if this was a comparison between this year and last year, rather than the company and the sector for the same period. Very few candidates mentioned the impact on ROCE, net asset turnover and gearing of the property revaluation; of those who did, a majority explained the effects incorrectly.

Question 3

This 30 mark consolidation question was in three parts with marked variations in candidate performance. Many candidates earned 7 or 8 marks for part (a), but few achieved any marks (where it was attempted) for part (c).

Part (a) was a goodwill calculation, the principles of which most candidates seem to be familiar with. Common errors were: taking the contingent consideration at the date of consolidation rather than the date of acquisition; incorrectly calculating (or excluding) the pre-acquisition profits for the first three months of the year or even deducing these from retained earnings brought forward (working backwards rather than forwards); omitting the provision for the onerous contract (by some margin this was the most common error in this part); deducting the goodwill impairment, which was not required by the question (candidates were not penalised for this, but did waste time showing this adjustment).

Part (b) required a consolidated statement of profit or loss and other comprehensive income incorporating the type of adjustments seen on many past papers. Many candidates scored well, although very few avoided making some errors.

The errors made by a substantial number of candidates included: not eliminating the dividend from the subsidiary on consolidation; showing the share of underlying profit from the associate and the dividend from the associate (already accounted for) without realising this was double counting; recognising the increase in the value of land at the date of acquisition as part of the other comprehensive income for the year (this was already part of the goodwill calculation); omitting the decrease in the contingent consideration; incorrectly treating the dividend (part of investment income) and gain on the fair value (part of other comprehensive income as stated in the question) of the equity investment.

Other errors made by a minority of candidates included: not time apportioning the revenue and expenses of the subsidiary; proportional consolidation of the revenue and expenses of the subsidiary; not correctly treating or calculating the unrealised profit on inventory held; making a time apportioned adjustment for the onerous contract provision (in the absence of any mention of the settlement of this liability no adjustment is needed in profit or loss); omitting the given goodwill impairment amount from operating expenses (or even disclosing it as part of other comprehensive income); omitting one or more of the adjustments to determine the non-controlling interest's share of the subsidiary's profit for the year.

Part (c) was a short written question testing the two alternative methods of valuing the non-controlling interest (NCI) and the effect these methods have on the treatment of goodwill. Previous F7 computation questions have used the (full) fair value method for valuing NCI and goodwill; this question concentrated on the different effect of using the proportionate share of a subsidiary's identifiable net assets method. Answers were either non-existent or clearly had no real understanding of either method or the differences between them. A good answer would have referred to the latter method computing goodwill without reference to the NCI and therefore both goodwill and the NCI would have lower reported values. The question also referred to the treatment of the impairment of goodwill; under the latter method goodwill needed to be "grossed up" to determine if there was any impairment; if there was any impairment only the parent's share of this should be charged against the parent's profit in the consolidated statement of profit or loss.

Conclusion

Generally, the performance on this paper was encouraging, but with room for improvement particularly on the written answers. Candidates are reminded of the importance of working through study resources provided by Approved Content Providers and the exam papers (and answers) made available on the ACCA website (including the specimen paper). The syllabus for this paper is recognised as extensive and candidates need to prepare for the whole syllabus. Once again, future candidates are reminded of the need for an appropriate level of workings to support answers which will allow markers to understand how figures used have been arrived at.

Many of the above comments, particularly in respect of the numerical questions, focus on where candidates made errors. This is intended as a guide to future studies and highlight poor techniques and approaches with a view to improving performance. There were also many excellent scripts that were rewarded appropriately.