Examiner's report

F7 Financial Reporting

September 2015

General Comments

There were two sections to the examination paper and all questions were compulsory. Section A consisted of 20 multiple-choice questions (two marks each) which covered a broad range of syllabus topics. Section B consisted of three questions (2 for 15 marks and one for 30 marks). These questions covered the main syllabus areas in more depth, supporting both financial statement preparation and interpretation skills.

The numerical aspects of the Section B questions were encouraging and it would appear that candidates are becoming increasingly familiar with IFRS terminology and formats. Basic errors seen previously, such as proportional consolidation, were very rare. The interpretation question was the weakest as candidates relied too heavily on the ratios and did not make sufficient use of the additional information provided ; for example, the timing of the changes in the second year and their influence on the results of that year.

Specific comments

Section A

It was pleasing to note that, once again, most candidates attempted all of the multiple choice questions. Candidates preparing for a subsequent F7 examination are advised to work through the pilot paper, past exam papers and the two sample questions from this paper provided below. The development of the correct answers in the two questions used below should be reviewed carefully as these are examples of questions where students made common errors. Section A questions will continue to provide a broad coverage of the syllabus and therefore candidates should aim to revise all areas of the F7 syllabus, rather than attempt to "spot questions". The following two questions are reviewed with the aim of giving future candidates a technical review of the question, guidance on how to approach such questions and an indication of the types of questions posed in Section A of the exam.

Sample questions for discussion

Example 1

Jetsam Co entered into a lease for an item of plant on 1 April 20X0 which required payments of $15,000 to be made annually in arrears. The fair value of the asset was estimated at $100,000 at the inception of the lease and Jetsam Co's cost of borrowing is 8%. The lease was for a three- year period and the plant's estimated economic life was ten years.

What amount should he charged to profit or loss relating to the lease for the year ended 31 December 20X0?

A $11,250
B $6,000
C $7,500
D $13,500

This question tested candidate's knowledge of lease agreements and the distinction between an operating and a finance lease. Although information was given that referred to a finance lease agreement for the asset, candidates were expected to understand that, by leasing the asset for only three years of its ten year life, it was an operating lease. The lease rental, as an expense, needed to be time apportioned at $15,000 x 9/12 = $11,250 = Answer A.

Many candidates treated the lease as a finance lease and calculated the depreciation charge ($100,000/10 years x 9/12 = $7,500 = Answer C) or the finance charge ($100,000 x 8% x 9/12 = $6,000 = Answer B) or combined the two charges to $13,500 (Answer D). As already noted this was an operating lease and therefore these figures were not appropriate in this case.

This topic covers a key area of financial statement preparation and leases have been regularly examined. The distinction between the two types of lease and the accounting treatment of both, following IAS 17 *Leases*, is a topic that future candidates should be aware of.

Example 2

Inventory may be measured on a first in, first out (FIFO) or a weighted average cost (WAC) basis. For property, plant and equipment (PPE) the choice is between the cost and revaluation models.

In a period of rising prices, which of the following combinations would lead to higher profitability ratios?

	Inventory	PPE
A	FIFO	Revaluation model
B	FIFO	Cost model
C	WAC	Revaluation model
D	WAC	Cost model

As the question gives all four combinations, and specifically mentions rising prices, it needed deductive reasoning to determine that the correct answer was B.

FIFO would give a lower cost of sales than WAC and therefore higher profits and profitability ratios (such as gross and operating profit margins). This would eliminate distractors C and D.
The PPE cost model would give lower depreciation charges than the revaluation model and therefore higher profits and lower capital employed (both combining to give a higher return on capital employed). This eliminates answer A.

The analysis of financial statements and the impact of alternative valuation models on financial ratios is a key area of the F7 syllabus and will continue to be examined in a variety of forms.

Section B

Question One

This was a fifteen mark question requiring the preparation of a statement of profit or loss and other comprehensive income and a statement of changes in equity for a single company using IFRS formats. This was generally well answered by candidates.

However, many candidates wasted valuable time by preparing lengthy journal entries to support the adjustments in the question. These were not necessary to answer the question and candidates should refer to similar F7 single company financial statement preparation questions in recent past papers. A number of candidates also prepared either the statement of financial position or supporting workings (such as non-current asset carrying amounts) which was also not necessary and earned them no marks.

It continues to be the case that, even at this level, a significant number of candidates cannot distinguish between straight line (cost-based) and reducing balance (carrying amount-based) depreciation. The question will always makes clear which method is to be used (and if time apportionment is to be used).

The finance cost of a loan note should, always be based on the effective cost (rather than the "coupon" rate) and, of course, time apportioned where necessary. In this question there was also an in-substance loan (based on a cash receipt treated as sales rather than a loan) which would also attract a finance charge based on the given rate of interest. Many candidates either ignored or incorrectly accounted for these costs.

The question included the revaluation of property and many candidates took the revaluation surplus as the difference between the asset's cost and fair value. The correct treatment is the difference between the asset's carrying amount and fair value.

In the statement of changes in equity, a majority of candidates worked forwards and, in effect, accounted for the share issue a second time. The information in the question stated the balances as at the reporting date so for this statement it was necessary to work backwards to determine the opening balances on share capital and share premium. The error with share capital meant that the dividend was calculated on the wrong number of shares, but candidates gained marks under the own figure rule for deducting dividends from retained earnings (those candidates who deducted dividends from other elements of equity did not obtain those marks).

Question 2

This was a two-part interpretation question with part (a) (for four marks) requiring candidates to calculate two specified ratios. There was sufficient information given in the question to indicate figures that should be included in, and excluded from, the ratios. The only exception was operating profit (or profit before interest and tax - the same figure in this question) which candidates were expected to use as the numerator for ROCE. Whilst many candidates, by showing full workings, gained all four marks there were others who had little idea of how to link the numerator and denominator to obtain meaningful ratios for both years.

Part (b) for 11 marks was less well answered. Many candidates simply repeated the ratios from part (a) and stated whether they had increased or decreased (not even suggesting whether they gave a better or worse position). The central aim of the question was to comment on the changes that had taken place during the second year, although these had only been implemented half way through the year so the results could not reflect a full year's benefit from them. Few candidates realised that, although there was only half a year's results from the changes in the statement of profit or loss, the statement of financial positon reflected the year-end position as a result of the changes. The changes made during the second year should lead to improved results in the future.

Although the basis of the ratio calculations was clearly stated in part (a), for part (b) candidates should have discussed the impact of the property revaluation (in the second year only) and the change from an operating lease to a finance lease. It was not necessary to recalculate numbers or new ratios to reflect these changes -

although many candidates wasted time by doing so - but to discuss their impact and the lack of direct comparability between the two year's financial statements as presented.

Question 3

This 30 mark question required the preparation of a consolidated statement of financial position which has been examined many times in the past (for 25 marks) and a short separate written relating to an associate (for 5 marks).

With respect to the goodwill calculation, the common problems were: (i) missing one or more elements of the calculation of the controlling or non-controlling interest at the date of acquisition; (ii) not correctly determining the pre-acquisition element of the retained earnings from the year of acquisition (a seasonal or a time-apportioned adjustment); (iii) adding the fair value adjustment of an asset where its fair value was less than its carrying value ; (iv) ignoring the intangible asset to be recognised by the parent on acquisition although this asset would not be separately recognised by the subsidiary in its own financial statements; and (v) ignoring the fair value adjustment (at acquisition) of the subsidiary's own financial asset investments.

For the consolidation itself common problems were: (i) not increasing the carrying amount of property, plant and equipment by the reduced depreciation charge from the fair value adjustment noted above (if the fair value of the asset is decreased then the post-acquisition depreciation charge should also be reduced); (ii) not amortising the intangible asset recognised separately in the goodwill calculation; (iii) using (in this case) margin rather than mark-up to determine unrealised profit on inventory held and in transit; (iv) not accounting correctly for goods in transit and inter-company balances and ensuring the correct elimination of items; (v) not correctly adjusting share capital and share premium from the purchase consideration calculated at the goodwill stage; (vi) not accounting for the deferred consideration or the outstanding interest (as a deduction from post-acquisition profits and an addition to the liability); and (vii) not accounting for the acquisition taking place part way through the year, thus requiring several items to be time apportioned.

Part (b) for 5 marks was generally poorly answered. It may be that candidates felt the 95% already completed would be sufficient to gain a pass mark, although there was no other evidence of particular time management problems and all three Section B questions were attempted by nearly all candidates.

The question required candidates to distinguish between the first part of the year when an investment was held as an associate (with a level of shareholding and board representation to give significant influence over the investee) and the second part of the year when, although the shareholding was unchanged, there was no longer any representation on the board. This change meant that there was no significant influence and it was no longer an investment in an associate and equity accounting could no longer be used. Few candidates appreciated the status of the investment changed once board representation was lost or that, from that point onwards it would be treated as an investment at fair value through profit or loss.

Conclusion

For this first September sitting, performance was generally good and encouraging. Candidates are, once again, reminded of the importance of reviewing past F7 papers to identify the skills required in applying their knowledge in the examination. An appropriate level of workings supports good answers and allows markers to understand how answers have been arrived at - excessively lengthy and absent workings do not allow that to happen. The

F7 syllabus is extensive but good exam (and exam preparation) techniques are just as important as learning the key elements of International Standards, with preparation and analytical skills.