Examiner's report

F7 Financial Reporting
September 2016

ACCA

General Comments
The September 2016 was sat by candidates using the traditional paper-based exam (PBE) and, for the first time, the new computer-based exam (CBE). The format of the exam was the same for PBE and CBE candidates. A new exam structure was introduced in September 2016 which will continue going forward. The exam comprised three sections and all questions were compulsory. Section A contained 15 2-mark individual objective test questions, (30 marks) Section B contained three objective test cases, with each case containing five 2-mark objective test questions (30 marks) and Section C consisted of two constructed response questions for 20 marks each (40 marks) which were expert marked. Sections A and B covered a broad range of the syllabus; Section C tested knowledge of financial statement preparation and interpretation of consolidated financial statements.

Overall performance on the Section A and B objective test questions was encouraging although the performance on Section C was a little disappointing. The Examining Team believes this might be for two reasons: in sufficient time devoted to Section C and the combination of interpretation and consolidation issues into one question. It is recognised that this has been the first time that interpretation and consolidation have been combined, although the information given and the structure of the question should have allowed candidates to work through both parts of the question in a logical manner.

It is essential that candidates prepare for the F7 examination by working through the examples provided in published past papers and the material provided by approved content providers. This material and past examiner's reports combine to give examples of all types of past questions and, where possible, a commentary on common errors and issues that have caused difficulty for candidates. The exam questions cover the whole syllabus and therefore candidates are required to have a broad knowledge of financial reporting rather than just revising what are deemed to be the main syllabus areas.

Specific comments

Section A
As might be expected, almost all candidates attempted all questions; as a last resort an educated guess is better than no answer at all. This report provides examples of two (three?) questions that proved to be particularly difficult for candidates.

Sample objective test questions for discussion
Example 1
On 1 January 20X6, Gardenbugs Co received a $30,000 government grant relating to equipment which cost $90,000 and had a useful life of six years. The grant was netted off against the cost of the equipment. On 1 January 20X7, when the equipment had a carrying amount of $50,000, its use was changed so that it was no longer being used in accordance with the grant. This meant the grant needed to be repaid in full, but by 31 December 20X7 this had not yet been done.

Which journal entry is required to reflect the correct accounting treatment of the government grant and the equipment in the financial statements of Gardenbugs Co for the year ended 31 December 20X7?

A	Dr	Property, plant and equipment	$10,000	
	Dr	Depreciation expense	$20,000	
	Cr	Liability		$30,000
B	Dr	Property, plant and equipment	$15,000	
	Dr	Depreciation expense	$15,000	
	Cr	Liability		$30,000
C	Dr	Property, plant and equipment	$10,000	
	Dr	Depreciation expense	$15,000	
	Dr	Retained earnings	$5,000	
	Cr	Liability		$30,000
D	Dr	Property, plant and equipment	$20,000	
	Dr	Depreciation expense	$10,000	
	Cr	Liability		$30,000

Commentary

This question tested candidates' understanding of the treatment of government grants, in particular the entries for the repayment of such a grant. The liability at 31 December 20X7 of $30,000 is clearly not an issue as all four alternatives recognise this balance as being the grant due for repayment. The correct answer was **A**: debit PPE $10,000 and debit depreciation expense $20,000.

At the start of the year, and without reference to the repayment of the grant, the net cost of the plant was $60,000 ($90,000 cost – $30,000 grant received) and therefore the annual depreciation was $10,000 ($60,000/6 years) and the carrying amount at the end of the year was $50,000 ($60,000 - $10,000) as stated in the question.

The repayment of the grant should be treated as a change in accounting estimate. We must increase the cost of the asset as we can no longer offset the grant and there will be a resulting change in depreciation. Without the grant the cost of the asset would have been $90,000 and depreciation would have been $15,000 a year ($90,000/6 years). The carrying amount at 31 December 20X7 should be $60,000 ($90,000 cost - $30,000 accumulated depreciation). We are required to increase the carrying amount by$10,000 debit to restore the plant's carrying amount from its opening carrying amount ($50,000) to the corrected carrying amount ($60,000). The $20,000 ($30,000 - $10,000) depreciation expense is the charge to profit or loss to reflect the amount of extra depreciation that should have been charged for the first two years.

Answer B is a similar adjustment, but assumes the adjustment at the end of the first year of the plant's useful life. Answer C attempts a prior period adjustment for the increased depreciation charge. This is not necessary as the financial statements prepared for 20X6 correctly reported the use of the asset in accordance with the terms of the grant. Answer D (the most popular response) assumes the depreciation for 20X7 has been charged in the financial statements already, but this is not the case; *all* the adjustments for 20X7 are needed for the correct answer.

Example 2
Patula Co acquired 80% of Sanka Co on 1 October 20X5. At this date, some of Sanka Co's inventory had a carrying amount of $600,000, but a fair value of $800,000. By 31 December 20X5, 70% of this inventory had been sold by Sanka Co.
The individual statements of financial position at 31 December for both companies show the following:

	Patula Co	**Sanka Co**
	$'000	**$'000**
Inventories	3,250	1,940

What will be the total inventories figure in the consolidated statement of financial position of Patula Co as at 31 December 20X5?

A	$5,250,000
B	$5,330,000
C	$5,130,000
D	$5,238,000

Commentary
The correct answer is **A**: $3,250,000 (Patula) plus $1,940,000 (Sanka) plus $60,000 (30% x ($800,000 - $600,000) fair value excess of inventory not sold) equals $5,250,000. The inventory of the subsidiary, Sanka Co, should be included at fair value at the date of acquisition. The inventory in the individual accounts of Sanka Co will be at cost and therefore an adjustment is needed to include the fair value of the unsold inventory. Answer B is incorrect as it adds $140,000 (fair value excess of inventory *sold*) (3,250 + 1,940 + (70% x 200) = 5,330). Answer C is incorrect as it *deducts* the fair value excess of the inventory not sold (3,250 + 1,940 - 60 = 5,130). Answer D is incorrect as it adds 80% of the fair value excess of inventory not sold (3,250 + 1,940 + 48 (80% x 60) = 5,238) and proportional consolidation, reflecting the parent's ownership interest in assets, is not an appropriate consolidation technique as it does not reflect *control* of those assets.

Section B
This section included three objective-test cases. Each case uses a common scenario as the basis for five 2-mark objective test questions. The first related to non-current assets, with particular emphasis on impairment; the second to lease agreements (using IAS 17); and the third to revenue (using IFRS 15) and income tax.

For the first scenario (questions 16 to 20) most questions were answered correctly by a substantial majority of candidates. The exception was the question requiring the allocation of an impairment loss where an asset was written down to a specific value first, then goodwill was written off entirely and the remaining impairment loss was split proportionately between the remaining non-current assets.

For the second scenario (questions 21 to 25) there were two questions that caused some difficulty. The first was in respect of an operating lease where no rental payment was made for the first year of the lease. Under the accruals concept (and IAS 17) the total rentals due are spread over the term of the lease, on a straight line basis, to determine the annual lease rental expense. The second question that caused difficulty was the treatment of profit on a sale and leaseback arrangement. The profit is the difference between the sale proceeds and the carrying amount (at the time of the sale and leaseback) and this is spread over the remainder of the asset's useful life or, if shorter, the remaining lease term.

For the third scenario (questions 26 to 30) the three revenue questions were generally well answered, but the two income tax questions caused difficulties. The first tax question asked about the impact of two property revaluations on the income tax expense. For a downward property revaluation (there had been no previous upward revaluation) the decrease is charged directly to profit or loss so the income tax expense will decrease by the tax share of the decrease. For the upward property valuation, a deferred tax charge arises and both are reported separately through other comprehensive income. The second tax question asked about development costs fully allowed for tax purposes where the deferred tax adjustment had not been made. This is an example of a taxable temporary difference as the expenditure will be amortised in the statement of profit or loss and therefore gives rise to a deferred tax liability, thus *increasing* the tax expense by the income tax rate applied to the development expenditure. More candidates said the tax expense would decrease than said it would increase.

Section C

Question 31
This was a 20 mark question requiring the calculation of a company's revised profit for the year and the statement of financial positon, including adjustments for: a convertible loan note, a mid-year leased property revaluation, a fraud (including a prior period adjustment) and taxation adjustments. This type of question has been examined before, including December 2014 (question 2, Kandy) and was commented on in the examiner's report for the March 2016 paper. The question was reasonably well answered with many candidates scoring at least half marks.
In part (a) a significant number of candidates were either not prepared to, or did not know how to, present the required schedule of adjustments. The starting point is the draft profit before interest and tax for the year given in the trial balance, followed by a series of relevant additions or subtractions to arrive at a figure of profit for the year. Frustratingly for markers, many candidates prepared a series of workings but did not attempt to either summarise these or state their effect on the statement of profit or loss, which restricted the number of marks that could be awarded. The requirement for a schedule is an alternative approach to the preparation of a full statement of profit or loss, whilst still testing key principles of profit measurement.
Future candidates should ensure that they avoid the common errors noted in this session.:

- Some candidates did not attempt to calculate the debt component of the convertible loan note and a few calculated interest at the underlying rate rather than the "coupon" rate.
- A number of candidates did not correctly split the amortisation of the leased property between the two halves of the year and often used an incorrect remaining useful life to determine the amortisation charge for the second half of the year.
- Many candidates did not correctly split the fraud between the amount related to the current year and the remainder which related to the previous year and therefore was not relevant to profit or loss.
- Some candidates included the estimated amount the directors hoped could be recovered from insurers (this was a contingent asset and, as many candidates correctly noted, should

be ignored).

- Candidate's understanding of current and deferred tax issues seems to have been a particular problem. In this case, the tax charge for the current year and the under-provision (a debit balance) for the previous year both reduce the profit for the year. Many candidates, in calculating the movement on the deferred tax provision, included the deferred tax element of the leased property revaluation in part (a). Both this amount, and the surplus to which it related, are reported under other comprehensive income and this was not required as part of the answer to part (a). The overall increase (in this case) in the deferred tax provision should have been split between the tax on the revaluation surplus and the balance (a credit in this case) which was part of the income tax expense.

Part (b) required the preparation of the statement of financial position incorporating figures in the given trial balance and the adjustments from part (a). In many instances common errors noted in part (b) were often errors followed through from part (a) although candidates are reminded that they would never be penalised twice for making an error. Other common errors noted in part (b) were:

- Some candidates did not include the equity component of the convertible loan note (even where this had been calculated) as an "other component of equity" and sometimes included it as a liability rather than equity.
- A number of candidates did not reduce the revaluation surplus by the deferred tax element or did not report the revaluation surplus at all.
- Candidates also incorrectly showed an incomplete (or omitted to show) deferred tax provision
- Some candidates included the convertible loan note as if at the end of the second year even though it was issued on the first day of the current year
- Some candidates omitted the current tax liability or incorrectly adjusted it by the under-provision for the previous year.
- Disappointingly, a few candidates who showed interest paid as a current liability which demonstrates a clear lack of understanding of basic principles.

Part (c) required a calculation of the company's potential diluted earnings per share for the year. This required the profit for the year (using the candidate's own figure) to be increased by the after-tax saving of interest on the convertible loan note, using the correct charge (debt component at the underlying interest rate) and the number of shares to be increased by the (maximum) number that could be issued on the conversion of the loan note. Many candidates either did not attempt this part of the question or made neither of the adjustments noted above. As the question did not ask for the basic earnings per share no marks were awarded for calculating it - the marks were specifically for the adjustments noted.

Question 32

This is the first time a question combining interpretation with an element of consolidation has been examined and candidates did find this a challenging question. The Examining Team felt the question was sufficiently well structured to have introduced the consolidation aspects gradually, with one party-owned subsidiary, acquired mid-year, for the second year only.

For part (a) the comments required in response to the Chief Executive Officer (CEO)'s four observations were not at the expected standard. Most candidates launched into irrelevant detail regarding ratio movements (even before they had been asked to calculate them - it was expected candidates would answer part (a) first) and did not step back and consider the reason for the difference between the two years' financial statements, specifically that the statement of profit or loss for the second year included the consolidated results of the newly-acquired subsidiary but, crucially, only for six months. In the statement of financial position, at the end of the second year, the subsidiary's assets were included on the basis of their fair values and those of the parent were at historical cost (in the absence of a revaluation surplus).

The inclusion next year of a full year's results for the subsidiary should improve the reported profitability of the group. There were two corrections to the CEO's calculation of earnings per share (EPS) (using the profit for the year attributable to the equity holders of the parent and the weighted average for the shares issued mid-year) but a majority of candidates missed both these adjustments although many did point out that the EPS had barely changed as although more shares had been issued, profit had increased. The low margin on inter-company sales was seen by many candidates as, correctly, not affecting the consolidated financial statements or the overall profitability of the group. Some candidates did mention the impact of any unrealised profit on inventories held from such trading, but this was not likely to have a material effect. The final observation was rarely addressed: candidates needed to work out the price at which the shares were issued by the parent (they were the only shares issued during the year) using the share capital and share premium figures and compare this with the 15% increase in the share price since acquisition as an indicator of the market's favourable view of the acquisition.

For part (b) the four ratio calculations were generally well done although: for ROCE, capital employed should include the non-controlling interest as this is part of equity (those who took total assets less current liabilities had no problem with this) and the calculation of net asset turnover (revenue/capital employed) was either omitted or the figures inverted. A minority of candidates attempted to adjust for the inter-company transactions before calculating ratios which was not required as we must assume that inter-company sales (and purchases) had already been correctly eliminated on consolidation.

For the comments on comparative performance, the usual observations on past papers continue to apply. To suggest ratios have increased or decreased does not qualify as analysis; suggesting the change is better or worse begins to show understanding, but more than this is required. In many cases the impact of the acquisition (as answered in part (a)) was completely ignored and candidates compared this year and last year results as if they were directly comparing like with like. An example of this is the impact of reporting just six months results for the subsidiary in the second year; this was often commented on in part (a) and then ignored in part (b).

The gross profit margin fell between the two years; this was the ultimate cause of the fall in the ROCE but, as was mentioned quite often, it is not enough to say gross margin fell because cost of sales increased without also suggesting prices may have fallen. The relationship between gross and operating profit margin was often misunderstood. Many candidates stated that the decrease in the operating margin was caused by increased operating costs when in fact operating costs were a lower % of revenue in the second year (despite any one-off costs of the acquisition) and the cause of the decrease was the reduction in the gross profit margin.

Very few candidates used the information in the question regarding the non-controlling interest in the subsidiary's profit to determine the subsidiary's possible contribution to the group's profit for the year and thus determine that there could have been a decline in the profit earned by the parent alone in the second year. Also the subsidiary's net assets (including goodwill) are included in the statement of financial position at their fair value (this was the reason the question said values of property, plant and equipment had been rising) but the parent's assets are still at their (lower) historical cost and this could distort comparison between the ROCE and asset turnover of both years.

Conclusion
Generally, recognising the change of format, the performance on this paper was fairly encouraging, but there is room for improvement particularly for the analysis and interpretation question. The F7 syllabus is extensive and good preparation covering the whole syllabus is required for success. Future candidates are advised to use all available study material to aid their preparation (including revision) across the whole syllabus. Although there is evidence of some improvement, candidates are reminded of the need for answers to be organised and with an appropriate level of workings to support their answers so that markers can understand how figures have been arrived at.

Many of the comments, particularly in respect of Section C, focus on where candidates made errors or otherwise lost marks. This report is intended as a guide to future candidates and highlights poor techniques and approaches with a view to improving performance. There were many excellent scripts and these were rewarded appropriately.