CORPORATE REPORTING

PROFESSIONAL 1 EXAMINATION - AUGUST 2020

NOTES:
You are required to answer Questions 1, 2 **and** 3. You are also required to answer **either** Question 4 **or** 5. Should you provide answers to both Questions 4 and 5, only your answer for Question 4 will be marked.

Provided are pro-forma:

Statements of Profit or Loss and Other Comprehensive Income By Expense, Statements of Profit or Loss and Other Comprehensive Income By Function, and Statements of Financial Position.

TIME ALLOWED:
3.5 hours, plus 10 minutes to read the paper.

INSTRUCTIONS:
During the reading time you may highlight text and write notes on the examination paper, however, you may not commence writing on the answer field until your Supervisor tells you to do so. Please read each Question carefully.

Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

You are reminded to pay particular attention to your communication skills, and care must be taken regarding the format and literacy of your solutions. The marking system will take into account the content of your answers and the extent to which answers are supported with relevant legislation, case law or examples, where appropriate.

CORPORATE REPORTING

PROFESSIONAL 1 EXAMINATION – AUGUST 2020

You are required to answer Questions 1, 2 and 3.

1. The following financial statements relate to Everett Plc (Everett) and its investee company, Redmond Plc (Redmond).

Statements of Profit or Loss for year ended 31 March 2020

	Everett Plc € million	Redmond Plc € million
Revenue	900	276
Cost of Sales	(420)	(132)
Gross profit	480	144
Administration expenses	(169)	(54)
Distribution costs	(35)	(24)
Other income	21	
Profit before taxation	297	66
Taxation	(36)	(6)
Profit for the year	261	60

Statements of Changes in Equity (Retained Earnings only) for year ended 31 March 2020

	Everett Plc € million	Redmond Plc € million
Balance 1 April 2019	289	57
Profit for the year	261	60
Dividends proposed	(32)	(24)
Balance 31 March 2020	518	93

Statements of Financial Position as at 31 March 2020

	Everett Plc € million	Redmond Plc € million
Non-current assets:		
Property, plant & equipment	580	260
Investments	400	30
	980	290
Current assets:		
Inventories	76	34
Trade receivables	58	53
Cash & bank	20	12
	154	99
Total assets	**1,134**	**389**

Equity:		
Equity share capital of €1 each	500	200
Share premium	25	30
Retained earnings	518	93
	1,043	323
Current liabilities:		
Trade payables	41	32
Taxation	18	10
Dividends proposed	32	24
	91	66
Total equity & liabilities	**1,134**	**389**

The following additional information is provided:

(i) Everett bought a 75% interest in the equity capital of Redmond on 1 August 2019. The cost of the investment was €300 million, paid in cash. It was decided to apply the fair value method to calculate goodwill on acquisition. On the acquisition date, the fair value of the non-controlling interest in Redmond was €95 million. Impairment losses of €10.3 million have occurred since acquisition.

(ii) At the date of acquisition Redmond had some specialised equipment that was deemed to have a fair value of €16 million in excess of its carrying value. This equipment had a 4-year useful economic life from its acquisition date.

(iii) On an even basis over the entire year, Redmond sold goods to Everett for €12 million. Redmond earns 25% margin on goods sold to Everett. €4 million of the goods purchased from Redmond remained in the inventory of Everett at 31 March 2020. This inventory consisted of goods that were all purchased in the post-acquisition period.

(iv) The remaining investments in the books of Everett consist of equity investments. These had a fair value of €96 million at 31 March 2020. No election was made under IFRS 9 to take gains or losses on any equity investments to Other Comprehensive Income.

(v) On 31 March 2020, both companies declared and correctly recorded proposed dividends. In the case of Redmond these were declared out of post-acquisition profits. Everett has not taken account of any dividends receivable.

(vi) All calculations may be taken to the nearest €0.1 million. Assume all expenses and gains accrue evenly throughout the year unless otherwise instructed. No new equity capital was issued by any group company during the year.

REQUIREMENT:

(a) Prepare, in accordance with IFRS, the Consolidated Statement of Profit or Loss and Other Comprehensive Income for the Everett group for year ended 31 March 2020.

(12 marks)

(b) Prepare, in accordance with IFRS, the Consolidated Statement of Financial Position for the Everett group as at 31 March 2020.

(18 marks)

[Total: 30 marks]

2. Vernon Plc is a public listed company. Its summarised consolidated financial statements for the year ended 31 March 2020 (with 2019 comparatives) are as follows:

Vernon Group Plc: Consolidated Statements of Profit or Loss and Other Comprehensive Income for the years ended 31 March

	2020	**2019**
	€ million	**€ million**
Revenue	836	466
Cost of sales	(395)	(230)
Gross profit	441	236
Operating costs	(169)	(78)
Gains on revaluation of financial assets	20	40
Share of results of associate company	14	0
Finance costs	(30)	(24)
Profit (loss) before taxation	276	174
Income tax expense	(28)	(21)
Profit for the year	**248**	**153**
Other Comprehensive Income		
Amounts that will not be reclassified to profit or loss		
Gains on revaluation of property	56	24
Total Comprehensive Income	**304**	**177**
Profit for the year attributable to:		
Owners of the parent	233	153
Non-controlling interests	15	0
Profit for the year	**248**	**153**
Total Comprehensive Income for the year attributable to:		
Owners of the parent	289	177
Non-controlling interests	15	0
Total Comprehensive Income for the year	**304**	**177**

Vernon Group Plc: Consolidated Statements of Financial Position as at 31 March

	2020	**2019**
	€ million	**€ million**
Non-current assets:		
Property, plant and equipment	2,105	1,560
Intangible assets	145	160
Goodwill	60	0
Investment in associate company	64	0
Financial assets	210	230
	2,584	1,950
Current assets:		
Inventory	346	245
Trade receivables	402	341
Bank	0	65
	748	651
Total assets	3,332	2,601
Equity:		
Equity shares of €1 each	1,150	1,000
Share premium	500	350
Revaluation reserve	96	40
Retained earnings	973	765
	2,719	2,155
Non-controlling interest	50	0
	2,769	2,155

Non-current liabilities:		
8% Debenture 2021	375	300
Current liabilities:		
Trade payables and provisions	110	125
Interest payable	6	0
Bank overdraft	52	0
Current tax payable	20	21
	188	146
Total equity and liabilities	3,332	2,601

The following information should be taken into account:

(i) Depreciation charged to profit or loss for the year was €235 million.

(ii) Equipment with a carrying value of €40 million was sold during the year for €56 million. Any gain or loss on disposal has been netted off under operating costs.

(iii) The group adopts the revaluation model of IAS 16 - *Property Plant & Equipment.*

(iv) Intangible assets were acquired during the year at a cost of €12 million. No disposals of intangibles occurred during the year.

(v) An associate company was purchased during the year for €54 million.

(vi) Financial assets with a carrying value of €40 million were sold during the year for €40 million. No purchase of financial assets took place during the year.

(vii) On 1 October 2019, the group made an investment in a subsidiary. It was decided to use the proportion of net assets method to value the non-controlling interest. The following information is relevant:

Cost of investment:	€300 million cash
Percentage acquired:	80%
Assets and liabilities of acquired entity at acquisition:	€ million
Property plant & equipment	240
Inventory	24
Trade receivables	22
Cash and bank balances	16
Trade payables	(10)
Total	€292

An impairment loss was recognised on consolidated goodwill, and correctly charged to operating expenses.

REQUIREMENT:

(a) Prepare, in accordance with IFRS, the Consolidated Statement of Cash Flows for Vernon Plc for year ended 31 March 2020.

(20 marks)

(b) Analyse the consolidated statement of cash flows you have prepared and discuss any insights into the financial health of Vernon Plc revealed by your analysis.

(10 marks)

[Total: 30 marks]

3. **The following multiple-choice question contains eight sections, each of which is followed by a choice of answers. Each question carries equal marks.**

1. The following figures appear in the inventory records of Birdie Ltd. on 31 March 2020.

Item	**Quantity**	**Cost per unit in €**	**Net Realisable Value per unit in €**
R45	20 units	25	32
R46	40 units	25	22

Under IAS 2 - *Inventory*, what figure should be reported as inventory in the statement of financial position as at 31 March 2020?

(a) €1,380
(b) €1,500
(c) €1,520
(d) €1,640.

2. Under the IAS 32 - *Financial Instruments: Presentation definition of a financial asset*, which of the following would NOT be considered a financial asset of an entity?

(a) Cash at bank.
(b) Trade receivables.
(c) Investment in the equity instruments of another entity.
(d) Debt instruments issued by the entity.

3. Eagle Ltd. offers a 12-month warranty on all goods sold. During the year ended 31 March 2020 it sold 14,000 units of product for total revenue of €700,000. At 31 March 2020, the directors estimated that 400 of these units would prove defective within the warranty period. The average cost of repairing each defective unit is expected to be €45 and the cost of replacing defective units is likely to be €40. There is an existing provision for warranty costs amounting to €20,000 carried in the books at 31 March 2020. This dates from 1 April 2019.

Which of the following is the correct accounting entry to record the above information?

(a) Debit profit or loss €16,000, credit provision €16,000.
(b) Debit profit or loss €18,000, credit provision €18,000.
(c) Credit profit or loss €4,000, debit provision €4,000.
(d) Credit profit or loss €2,000, debit provision €2,000.

4. IFRS 9 - *Financial Instruments:* Recognition and Measurement sets out two tests which help determine whether a financial asset should be measured at fair value or at amortised cost. The Cash Flow test requires that cash flows from the asset must be generated from interest and principal only. The Business Model test requires that the business plans to hold the asset to draw its contractual cash flows.

Which of the following is true?

(a) Assets that meet the Business Model test only are accounted for under the amortised cost method.
(b) Assets that meet the Cash Flow test and the business model test are accounted for at fair value.
(c) Assets that meet the Cash Flow test only are accounted for at fair value.
(d) Assets that meet neither test are accounted for under the amortised cost method.

The following information in respect of Albatross Ltd. is relevant to answering parts 5-8 below. Assume all relevant information is included.

Statement of Profit or Loss and Other Comprehensive Income for year ended 31 March 2020

	€ million
Sales revenue	540
Cost of sales	(300)
Gross profit	240
Expenses	(130)
Profit before tax	110
Taxation	(14)
Profit for the year	96
Other comprehensive income	23
Total comprehensive income for the year	119

Other balances at 31 March 2020	**€ million**
Equity capital (€0.50 each)	200
Retained earnings (net of equity dividends paid €80 million)	790
Other equity components	220
Total equity	1,210

Note: No long-term debt.

5. What was the basic earnings per share for year ended 31 March 2020, calculated in accordance with IAS 33?

(a) €0.24
(b) €0.2975
(c) €0.48
(d) €0.595.

6. If the share price is €3.50 per share on 31 March 2020 and the dividend is projected to increase by 12% what is the prospective dividend yield for the coming year?

(a) 6.4%
(b) 7.4%
(c) 7.68%
(d) 12.8%.

7. What is the return on capital employed for the year ended 31 March 2020 (to one decimal place)?

(a) 7.9%
(b) 9.1%
(c) 9.8%
(d) None of the above.

8. The gross margin for year ended 31 March 2019 was 40%. Sales revenue for year ended 31 March 2019 was €400 million. Which of the following is true?

(a) Gross profit has remained the same from 2019 to 2020.
(b) Cost of sales for year ended 31 March 2019 was €160 million.
(c) Gross profit has decreased from 2019 to 2020.
(d) Cost of sales for year ended 31 March 2019 was €240 million.

[Total: 20 marks]

Answer either question 4 or question 5

4. The International Accounting Standards Board (IASB) issued a revised version of the Conceptual Framework for Financial Reporting in 2018. This revised framework document offers increased clarity on some matters, updates others and provides new material to fill gaps left unanswered by previous versions of the Conceptual Framework.

It is apparent from studying the document that the qualitative characteristics of 'relevance and 'faithful representation' form the basis for deciding whether information is useful. Judgments regarding the recognition, derecognition and measurement of elements of financial statements hinge on whether such decisions improve the usefulness of the financial statements. Information is useful if it is relevant and is faithfully representative of reality.

REQUIREMENT:

(a) Analyse the concepts of 'relevance' and 'faithful representation' as described by the 2018 Conceptual Framework for Financial Reporting.

(8 marks)

(b) Discuss when an asset and a liability should be recognised and derecognised in the financial statements, according to Chapter 5 of the 2018 Conceptual Framework.

(12 marks)

[Total: 20 marks]

5. IFRS 16 - *Leases* sets out guidance for accounting for contracts that are classified as leases. It can be stated that the application of certain IFRS 16 principles is an example of “substance over form”.

On 1 April 2019, Roundpole Ltd. entered into a contract to acquire a specialised piece of equipment. The agreement provided for 4 annual payments of €15.5 million, commencing on 31 March 2020. In addition, payment of a deposit of €30 million was required on 1 April 2019. The agreement also provided that Roundpole Ltd. could buy the residual asset outright at the end of the term for a nominal sum of money. At 1 April 2019, the fair value of the equipment was €80 million. The present value of the agreed deposit & lease payments is also €80 million. At 1 April 2019, the effective finance cost implicit in the contract is 9.2%. The equipment has a useful economic life of 5 years.

REQUIREMENT:

(a) Critically discuss the concept of ‘substance over form’ and explain why applying the principles of IFRS 16 is a good example of the concept being applied.

(8 marks)

(b) Demonstrate, with appropriate calculations, the accounting entries required to record the transaction above for year ended 31 March 2020. Present relevant extracts from the Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 March 2020 and the Statement of Financial Position as at that date.

(12 marks)

[Total 20 marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

CORPORATE REPORTING

PROFESSIONAL 1 EXAMINATION – AUGUST 2020

SOLUTION 1

Marking Scheme:

(a)	Basic consolidation (100% Everett + 100% Redmond * 8/12)	4
	Removal of intra-group revenue and purchases	1
	Calculation and inclusion of unrealised profit in cost of sales	1
	Calculation and inclusion of depreciation on fair value adjustment	1
	Inclusion of goodwill impairment	1
	Inclusion of loss on remeasurement of investments	1
	Calculation of NCI share in profit for year	2
	Presentation	1
	Subtotal	12
(b)	Basic consolidation (100% Everett + 100% Redmond)	4
	Calculation and inclusion of fair value adjustment within non-current assets	1
	Calculation and treatment of goodwill (including NCI at acquisition date)	4
	Calculation of correct investments figure	1
	Elimination of unrealised profit from inventory	1
	Dividends proposed	1
	Retained earnings calculation and consolidation	4
	NCI calculation and consolidation at reporting date	2
	Presentation	1
	Subtotal max	18
	Total	**30**

SUGGESTED SOLUTION

(a) Everett Plc: Consolidated Statement of Profit or Loss and Other Comprehensive Income for year ended 31 March 2020

	100% Everett + 100% Redmond * 8/12	€ million
Revenue	(900 + (276 * 8/12) - 8 (W5))	1,076.0
Cost of Sales	(420 + (132 * 8/12) - 8 (W5) + 1 (W5) +2.7 (W4))	(503.7)
Gross Profit		572.3
Administration expenses	(169 + (54 * 8/12) + 10.3 (W1))	(215.3)
Distribution costs	(35 + (24 * 8/12))	(51.0)
Other income	(21)	21.0
Loss on remeasurement of financial assets	W7	(4.0)
Profit before taxation		323.0
Taxation	(36 + (6 *8/12))	(40.0)
Profit for the year		283.0
Profit for the year is attributable to:		
Owners of the parent		276.5
Non-controlling interests	W8	6.5
		283.0

(b) Everett Plc: Consolidated Statement of Financial Position as at 31 March 2020

		€ million
Non current assets:		
Property, plant and equipment	(580 + 260 +13.3 (W4))	853.3
Goodwill	W1	61.7
Investments	(400 + 30 - 300 - 4 (W7))	126.0
		1,041.0
Current assets:		
Inventories	(76 + 34 -1 (W5))	109.0
Trade receivables	(58 + 53)	111.0
Cash & bank	(20 + 12)	32.0
		252.0
Total assets		**1,293.0**
Equity:		
Equity shares		500.0
Share Premium		25.0
Retained earnings	W2	533.5
		1,058.5
Non-controlling interest	W3	95.5
		1,154.0
Current liabilities:		
Trade payables	(41 + 32)	73.0
Dividends proposed	(32 + 24 -18 (W6))	38.0
Current taxation	(18 + 10)	28.0
		139.0
Total equity & liabilities		**1,293.0**

Workings:
Group structure:
Everett has 75% (controlling) equity in Redmond, bought 8 months prior to the reporting date

W1 - Goodwill on acquisition of Redmond		**€ million**
Cost of investment:		300.0
Value of NCI at acquisition (i)		95.0
Fair value of net assets at acquisition		
Equity share capital	200	
Share premium	30	
Retained earnings (see note below)	77	
Fair value adjustment (W4)	16	(323.0)
Goodwill		72.0
Impairment loss (i)		(10.3)
Balance to consolidated SOFP		61.7

Action:		
SOFP		
Deduct from R/E of Redmond		10.3
Add to Group Non-current assets		61.7
SPLOCI		
Include as expense	NCI is affected	10.3

Note: Retained earnings of Redmond at acquisition are calculated from the information given in the statement of changes in equity. Opening R/E were €57 million, but the acquisition date was 4 months later. By that date 4/12 of the year's profit had been earned (4/12 * 60 = 20) and no dividend had been declared or paid. Hence the retained earnings at the acquisition date were (57 + 20) €77 million.

W2 Retained earnings	Everett	Redmond
	€ million	**€ million**
Balance at reporting date	518.0	93.0
less balance at acquisition		(77.0)
goodwill impairment (i)		(10.3)
Dividends receivable (W6)	18.0	
Loss on remeasurement of investments (W7	(4.0)	
Depreciation on fair value adjustment (W4)		(2.7)
Unrealised profit on intra-group trading (W5)		(1.0)
Subtotals		2
Consolidate Redmond (75% * 2)	1.5	
Balance to SOFP	533.5	

W3 - Non-controlling Interest		Redmond
		€ million
Balance at acquisition (W1)		95.0
Share of retained earnings of Redmond	(25% * 2)	0.5
Balance to SOFP		95.5

W4 - Fair value adjustment		€ million
Balance at acquisition	to goodwill working	16.0
Depreciation since acquisition	16 / 4 years * 8/12	(2.7)
Balance at reporting date	to PPE in SOFP	13.3
Action:		
SOFP		
Deduct from R/E of Redmond		2.7
Add to Group PPE		13.3
SPLOCI		
Include as expense (Cost of Sales)	NCI is affected	2.7

W5 - Intra-group trading		€ million
Total goods traded intra-group	8 months post-acquisition	8.0
Unrealised profit	4 * 25%	1.0
Action:		
SOFP		
Deduct from R/E of Redmond		1.0
Deduct from group inventory		1.0
SPLOCI		
Deduct from revenue		8.0
Deduct from cost of sales		8.0
Add to cost of sales (Redmond)	NCI is affected	1.0

W6 - Intra-group dividends		€ million
Everett is due to receive 75% of Redmond's dividend proposed	**(24 * 75%)**	**18.0**
Action:		
SOFP		
Add to retained earnings of Everett		18.0
Deduct from dividends proposed of Redmond	18.0	
SPLOCI		
No entry required		

W7 - Investments		**€ million**
Loss on remeasurement of investments to fair value	(100-97)	(4.0)
Action:		
SOFP		
Deduct from investments		4.0
Deduct from retained earnings of Everett		4.0
SPLOCI		
Include as expense	NCI is not affected	4.0

W8 - Non-controlling interest in profit for year	**€ million**	
Profit for year (per question)		60.0
Post acquisition portion	8/12 * 60	40.0
Goodwill impairment	W1	(10.3)
Depreciation on fair value adjustment		(2.7)
Unrealised profit in intra-group trading		(1.0)
Adjusted profit for year		26.0
NCI percentage		25%
NCI share		6.5

Note: The adjustments affecting the subsidiary must be considered when calculating the non-controlling interest's share in the profit for the year. Goodwill impairment is also considered as the fair value method was used in calculating goodwill at acquisition. Hence the impairment should be shared between all shareholders, parent and NCI.

Study note: The consolidated statement of changes in equity links both of the above together. This was not required by the question, but is included below in case any student might find it useful.

Everett Plc: Statement of Changes in Equity for year ended 31 March 2020

	Equity SC	**Share P**	**R/Earnings**	**Subtotal**	**NCI**	**Total**
	€ million	**€ million**	**€ million**	**€ million**	**€ million**	**€ million**
Balance 1 April 2019	500.0	25.0	289.0	814.0	0.0	814.0
Acquisition 1 August '19					95.0	95.0
Profit for the year			276.5	276.5	6.5	283.0
Dividends proposed and paid			(32.0)	(32.0)	(6.0)	(38.0)
Balance 31 March 2020	500.0	25.0	533.5	1,058.5	95.5	1,154.0

(c) According to IFRS 9, equity investments should be carried at fair value at the reporting date. Any gain or loss on remeasurement of the carrying value should be taken to profit or loss. Hence, this is the treatment adopted by me in this solution.

IFRS 9 permits an entity to make an irrevocable election at the date of purchase of equity investments. The effect of this election is that any gains or losses on remeasurement of these investments is taken to other comprehensive income rather than to profit or loss. Had the election been made in this case, the loss of €4 million would have been recognised in the OCI section of the performance statement.

SOLUTION 2

Marking Scheme:

(a) Consolidated Statement of Cash Flows

Profit before tax	0.5
Finance costs	0.5
Share of results of associate	0.5
Gain on revaluation of financial assets	0.5
Depreciation	0.5
Gain on disposal of PPE	0.5
Amortisation of intangibles	1
Impairment of goodwill	1
Increase in inventory	1
Increase in trade receivables	1
Decrease in trade payables	1
Taxation paid	1
Interest paid	1
Proceeds of sale of equipment	0.5
Payments to acquire intangible assets	0.5
Payment to acquire associate	0.5
Payment to acquire subsidiary	0.5
Payments to acquire PPE	2
Dividend received from associate	1
Proceeds of sale of financial assets	0.5
Proceeds of issue of equity shares	0.5
Equity dividends paid	1
Dividends paid to Non-controlling interests	1
Proceeds of issue of debenture	0.5
Net cash flow for the year	
Opening cash and cash equivalents	0.5
Closing cash and cash equivalents	
Presentation	1
Subtotal	20

(b) Analysis

Ten valid points @ 1 mark each	10
Subtotal	10
Total	**30**

SUGGESTED SOLUTION

(a) Vernon Group Plc: Consolidated Statement of Cash Flows for year ended 31 March 2020

		€ million
Operating Activities		
non-cash adjustments		
Profit before tax	SPLOCI	276.0
Finance costs	SPLOCI	30.0
Share of results of associate	SPLOCI	(14.0)
Gain on revaluation of financial assets	SPLOCI	(20.0)
Depreciation	note (i)	235.0
Gain on disposal of PPE	(56 - 40)	(16.0)
Amortisation of intangibles	W1	27.0
Impairment of goodwill	W1	6.4
Increase in inventory	W2	(77.0)
Increase in trade receivables	W2	(39.0)
Decrease in trade payables	W4	(25.0)
		383.4
Taxation paid	W4	(29.0)
Interest paid	W4	(24.0)
Net cash flow from operating activities		**330.4**

Investing Activities		
Proceeds of sale of equipment	note (ii)	56.0
Payments to acquire intangible assets	note (iv)	(12.0)
Payment to acquire associate	note (v)	(54.0)
Payment to acquire subsidiary	300 - 16	(284.0)
Payments to acquire PPE	W1	(524.0)
Dividend received from associate	W1	4.0
Proceeds of sale of financial assets	note (vi)	40.0
Net cash flow from investing activities		**(774.0)**

Financing Activities		
Proceeds of issue of equity shares	W3	300.0
Equity dividends paid	W3	(25.0)
Dividends paid to Non-controlling interests	W3	(23.4)
Proceeds of issue of debenture	W4	75.0
Net cash flow from financing activities		326.6

Net cash flow for the year	(117.0)
Opening cash and cash equivalents	65.0
Closing cash and cash equivalents	**(52.0)**

Workings:

W1 - Non-current Assets	**PPE € million**	**Intangible € million**	**Goodwill € million**	**Associate € million**	**Financial € million**
Balance 1 April 2019	1,560.0	160.0	0.0	0.0	230.0
Profit or loss	(235.0)	(27.0)	(6.4)	14.0	20.0
OCI	56.0				
Disposal	(40.0)				(40.0)
Acquisition of sub	240.0		66.4		
Acquired for cash	524.0	12.0		54.0	
Dividend received				(4.0)	
Balance 31 March 2020	**2,105.0**	**145.0**	**60.0**	**64.0**	**210.0**

W2 - Current assets	**Inventory € million**	**Receivables € million**
Balance 1 April 2019	245.0	341.0
Acquisition of sub	24.0	22.0
Adjustment to SOCF	77.0	39.0
Balance 31 March 2020	**346.0**	**402.0**

W3 - Equity	**Share Cap € million**	**Share Prem € million**	**Revaluation € million**	**R/E € million**	**NCI € million**
Balance 1 April 2019	1,000.0	350.0	40.0	765.0	0.0
SPLOCI			56.0	233.0	15.0
Acquisition					58.4
Cash	150.0	150.0		(25.0)	(23.4)
Balance 31 March 2020	**1,150.0**	**500.0**	**96.0**	**973.0**	**50.0**

W4 - Liabilities	**Debenture € million**	**Payables € million**	**Taxation € million**	**Interest € million**
Balance 1 April 2019	**300.0**	**125.0**	**21.0**	**0.0**
Profit or loss			28.0	30.0
Acquisition of sub		10.0		
Cash	75.0		(29.0)	(24.0)
Adjustment to SOCF		(25.0)		
Balance 31 March 2020	**375.0**	**110.0**	**20.0**	**6.0**

W5 - Acquisition (goodwill calculation)€ million

Cost of investment		300.0	Cash outflow net of cash received
Value of NCI	(20% * 292)	58.4	Increase NCI
FV of NA acquired		(292.0)	Update relevant accounts except cash
Goodwill		66.4	Increase goodwill

(b) The following points could be made as part of a high-quality answer

The overall cash position has deteriorated over the year, going from #65 million positive to €52 million negative. This deterioration however masks significant changes in the composition and activities of the company. There was a significant acquisition during the year, which was cash neutral in the sense that Vernon raised €300 million in new equity to fund a net cash outflow on the acquisition of €284 million.

The combined entity has sales revenue 80% higher than Vernon alone had the previous year. However this understated the effect of the acquisition, as the subsidiary was acquired half way through the year. This means only half the revenue from that company will have been included in group revenue. Hence a further significant increase in reported revenue can be expected for the year ended 31 March 2021.

Given that the acquisition was not responsible for the reduction in cash balances, where then did it go?

Perusal of the statement of cash flows identifies a number of major outflows of cash. By far the most significant of these is the acquisition of property plant and equipment. Over €500 million was invested in this during the year, exceeding the depreciation charge by a significant margin. This suggests that Vernon Plc is expanding its operations significantly. Any capital investment in excess of depreciation suggests expansion.

Working capital items have collectively absorbed €141 million. This is a very significant increase in inventory, receivables and coupled with a reduction in trade payables, has resulted in the total cash outflow of €141 million. This again suggests major expansion, but the company must be careful not to overtrade. Overtrading is when operations expand beyond the ability of the available capital to support it.

In this case, whilst the rapid outflow of cash is somewhat alarming, the current ratios are solid, and the cash generated from operations is still highly positive at €330 million. That suggests that the business is well capable of recovering its cash flow once the increased sales and profits from the acquisition and expansion begin to flow through as cash.

It is comforting to know the company can issue new equity as it has done so already in the current year. Also, if there is a cash crunch for any reason, there are ample financial investments. While we have no information as to the liquidity of these, should they be easily marketable, they do provide a buffer.

Overall, it seems that the company is suffering a temporary decline in cash availability due to massive expansion. Should this expansion lead to greater sales and cash flows, as seems probable, the business should return to a healthy cash position.

SOLUTION 3

Each correct mark gains 2.5 marks. No partial marks are awarded. Workings are not marked.

1 **Answer (a)**

Each item is measured at the lower of cost and net realisable value. Item R45 is valued at (20 * 25) €500, and item R46 at (40 * 22) €880. Total €1,380.

2. **Answer (d)**

Debt instruments issued by the entity are classified as financial liabilities.

3. **Answer (c)**

The required provision is the expected number of defective items times the minimum cost of honouring the obligation. Hence 400 units * €40 or €16,000 is the required provision. As there is an existing provision of €20,000, a reduction of €4,000 is required. This is recorded by crediting profit or loss and debiting the provision.

4. **Answer (c)**

If both tests are met, the amortised cost method should be used. If either or both tests is not met, the fair value method should be used.

5. **Answer (a)**

IAS 33 earnings per share is defined as the profit for the year attributable to equity holders divided by the number of equity shares. Here, that is 96 / 400 = 24c. OCI is excluded by definition.

6. **Answer (a)**

The projected dividend per share is 80/400 * 1.12 = 22.4c. Hence the prospective yield is 22.4/350 = 6.4%

7. **Answer (b)**

ROCE is the profit before interest and tax expressed as a percentage of equity plus debt. Here, that is 110 / 1,210 = 9.09%, or 9.1%.

8. **Answer (d)**

Gross margin of 40% implies gross profit must have been €160 million. Hence cost of sales must have been €240 million (400 – 160).

SOLUTION 4

Marking Scheme:

(a)	Relevance	4
	Faithful Representation	4
	Subtotal	8
(b)	Recognition	6
	Derecognition	6
	Subtotal	12
	Total	**20**

SUGGESTED SOLUTION

(a) Fundamental Characteristics are characteristics that distinguish useful information from that which is non-useful. There are two such characteristics identified by the framework.

1. Relevance
   Information should have the ability to influence decisions. This means it should have either predictive value or confirmatory value. Materiality is an entity-specific aspect of relevance. Information is material if omitting it could influence decisions that users make about a specific reporting entity.

2. Faithful representation
   Information should faithfully represent the substance of what it purports to represent. This is more than just the absence of untruthful information. It is possible to be truthful and still not be faithful to reality. Yet this does not mean information needs to be perfectly accurate. Information often depends on estimates and the accuracy of these estimates sometimes cannot be determined. However the information would still be considered faithful if the uncertainties are managed honestly, and any material uncertainty disclosed. To be faithful, information should be:

   o Complete (no material information omitted);
   o Neutral (cautious but unbiased estimates are used wherever necessary);
   o Free from material error;
   o Prepared on the basis of substance over form.

(b) Recognition of an element simply means including it in the financial statements. Derecognition means removing an element from the financial statements. This chapter of the conceptual framework gives guidance on when to include and remove elements from the financial statements.

These criteria mainly refer to assets and liabilities, as equity, expenses and gains are the consequences of movements in the carrying values of assets and liabilities (as per the definitions provided by chapter 4). It is often the case that the decision to recognise or derecognise an asset or liability automatically triggers the recognition of a gain or loss through the operation of the double entry system.

The criteria for recognition and derecognition are based on the qualitative characteristics discussed in chapter 2, particularly the fundamental ones.

Recognition
Recognition is defined as the process of capturing for inclusion in the financial statements an item that meets the definition of an asset, liability, equity, income or expense. It is possible that an item that meets the definition in chapter 4 fails to meet recognition criteria, and may not be recognised as a result.

Recognition is appropriate if it results in both relevant information about an element and a faithful representation of those items (the fundamental qualitative characteristics of useful financial information). Remember the overall purpose of our endeavour is to provide useful information to aid the decisions of the providers of resources to the entity (as per chapter 1). Useful information is deemed to possess these two fundamental characteristics. Hence it is appropriate that recognition should depend on the information provided being relevant and faithfully representing reality.

Recognition might not happen on the basis of relevance if there is an existence uncertainty or a low probability of economic benefits being received by the entity. For example a customer owes the entity €10,000 but is in liquidation, and it is considered unlikely that the debt will be recovered. No trade receivable would be recognised by the entity.

Recognition might not happen on the basis of faithful representation if there was a measurement uncertainty. An example of this is the issue of internally generated intangibles. Existence might not be in question, but recognition might not happen due to an inability to measure the asset's cost or value reliably.

Derecognition

Derecognition is defined as the removal of an element from the financial statements.

For an asset, derecognition normally occurs when the entity loses control of a recognised asset. The most common example of this is the sale of an asset. Another example is the payment to the entity of a receivable by the debtor.

For a liability, derecognition occurs when the entity no longer has a present obligation for the liability. This could be due to discharge, when the entity performs the obligation associated with the liability, or due to changing circumstances rendering the liability void.

For both assets and liabilities, partial derecognition is required when appropriate, for example when a liability is partially discharged.

SOLUTION 5

Marking Scheme:

(a)	Explain "substance over form"	4
	Explain why IFRS 16 is a good example of substance over form	4
	Subtotal	8
(b)	Journal entry to capitalise asset and liability	1
	Treatment of initial deposit	1
	Depreciation	2
	Finance cost2	
	Lease payment	2
	Split between current liability and non-current liability	2
	Financial statement extracts	2
	Subtotal	12
	Total	**20**

SUGGESTED SOLUTION:

(a) Substance over form is a concept that is deemed essential in order that financial statements can be considered to be a faithful representation of reality. It is mentioned in the conceptual framework as part of the qualitative characteristics of financial information, particularly "faithful representation".

"Form" means the legal construct of a transaction. It can be defined by contract, verbal or written, or simply implied by the actions of the parties to the transaction.

"Substance" refers to the commercial effect of a transaction.

In most cases, the form and substance are exactly the same, and in these cases no issue arises. However, sometimes the commercial reality of a transaction differs from its legal form. This can be due to many factors. Examples include tax avoidance, limitation of liability, protection of legitimate interests, and indeed intentional misrepresentation of reality.

In these cases where substance and form differ, we are required to account for transactions in accordance with their substance.

One excellent example of a transaction where the substance differs from the form is a lease where substantially all the economic benefits deriving from an asset are transferred from the lessor to the lessee.

The legal form of any lease is that of a rental agreement. The lessor grants the lessee the right to use the asset for a specified period of time in return for a payment. The ownership of the asset remains with the lessor throughout.

For some leases, the commercial substance is different. The terms of some leases are such that the lessee is effectively paying for the entire economic benefit associated with the leased asset, and it is understood that the residual value remaining at the expiry of the lease will be negligible, or will transfer to the lessee for a nominal payment. In this case, the commercial substance of the transaction is more like a purchase with a finance agreement than a lease.

In the above scenario, IFRS 16 requires that the transaction be accounted for as a purchase, and the present value of the lease payments be accounted for as a loan. This is despite the legal fact that ownership title will not transfer to the lessee until all agreed payments have been made. The effect is that the risks and rewards are "in substance" associated with the asset accrue to the lessee. Hence the asset should be accounted for as such.

(b)

(i) As the present value of the minimum lease payments is equal to the fair value of the leased asset we can conclude that all the risks and rewards associated with the leased asset are borne by the lessee from the inception date.

Hence, the asset should be capitalised in the books of Roundpole Ltd on 1 April 2019, and depreciated from that date over 5 years.

The lease obligation should be recognised as a liability at the same date, and amortised using the effective rate of 9.2%.

Journal entries are as follows:	**Dr € million**	**Cr € million**
1 April 2019		
Dr Property, plant & equipment	80	
Cr Lease obligation		80
(acquisition of plant under lease)		
Dr Lease obligation	30	
Cr Cash		30
(payment of deposit required under the lease)		
31 March 2020		
Dr profit or loss (80 / 5 years)	16	
Cr Accumulated depreciation PPE		16
(depreciation of leased asset)		

Tutorial note: IFRS 16 requires that a leased asset be depreciated over the shorter of the lease term or the useful economic life of the asset unless it is virtually certain that the option to purchase will be exercised at the end of the lease term. If so, the useful economic life of the asset should be used. It appears to be virtually certain in this case that the option to purchase will be exercised.

31 March 2020		
Dr profit or loss (50 * 9.2%)	4.6	
Cr Lease obligation		4.6
(finance cost on remaining lease obligation)		
31 March 2020		
Dr Lease obligation	15.5	
Cr Cash		15.5

Tutorial note:
The closing lease obligation is 80 – 30 + 4.6 - 15.5 = €39.1 million
This is recorded as a liability at 31 March 2020.
In order for the liability to be recorded correctly, it must be split into current and non-current. The current liability is the amount of the €39.1 million that will be repaid within 12 months. This is equal to €15.5 million due in 12 months less the finance cost for the next 12 months (39.1 * 9.2% = €3.6 million). Hence the current liability will be €11.9 million.

Roundpole Ltd: Statement of Profit or Loss for year ended 31 March 2020 (Extract)

	€ million
Depreciation of leased asset	16
Finance cost	4.6

Roundpole Ltd: Statement of Financial Position as at 31 March 2020 (Extract)

	€ million
Non-current assets:	
Property plant & equipment (80 – 16)	64
Non-current liabilities:	
Lease obligation (39.1 – 11.9)	27.2
Current liabilities:	
Lease obligation	11.9