CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

CORPORATE REPORTING

PROFESSIONAL 1 EXAMINATION - APRIL 2017

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, you must draw a clearly distinguishable line through the answer not to be marked. Otherwise, only the first answer to hand for Question 4 or 5 will be marked.

Note: You have optional use of the Extended Trial Balance, which if used, must be included in the answer booklet.

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 write notes on the examination paper, but you may not commence writing in your answer book. **Please read each Question carefully.**

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

Start your answer to each question on a new page.

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.

List on the cover of each answer booklet, in the space provided, the number of each question attempted.

NB: PLEASE ENSURE TO ENCLOSE YOUR ANSWER SHEET TO QUESTION 3 IN THE ENVELOPE PROVIDED.

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

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

1. The following Statements of Profit or Loss and Other Comprehensive Income relate to Kildome Plc (Kildome) and its investee companies, Milhouse Plc (Milhouse) and Flanders Plc (Flanders).

Statements of Profit or Loss and Other Comprehensive Income for year ended 31 March 2017

	Kildome Plc	**Milhouse Plc**	**Flanders Plc**
	€ '000	**€ '000**	**€ '000**
Revenue	3,500	760	900
Cost of Sales	(2,000)	(320)	(300)
Gross profit	1,500	440	600
Operating expenses	(210)	(160)	(240)
Finance costs	(30)	(20)	(40)
Other income	20	-	80
Profit before taxation	1,280	260	400
Taxation	(150)	(60)	(40)
Profit for the year	1,130	200	360
Other comprehensive income			
(amounts that will not be reclassified to profit or loss)			
Gains on revaluations of property	60	-	-
Total comprehensive income for the year	1,190	200	360

The following additional information is provided:

(i) Kildome bought a 70% holding in the voting equity of Milhouse on 1 July 2016. The purchase price of the investment was agreed at €2.5 million. The 30% non-controlling interest in Milhouse had a fair value of €1 million at that date. Milhouse's identifiable net assets had a fair value of €3 million on 1 July 2016. It was decided to apply the fair value method to calculate goodwill on acquisition, as permitted by IFRS 3 - *Business Combinations*.

(ii) Kildome purchased 30% of the voting equity of Flanders on 1 October 2016. Kildome exerts significant influence over Flanders because of this investment.

(iii) Goodwill of Milhouse was reviewed for impairment at 31 March 2017 and was found to have suffered an impairment loss of €30,000. The 30% investment in Flanders was reviewed for impairment at 31 March 2017 and found to have suffered an impairment of €25,000.

(iv) Included in Milhouse's net assets on the acquisition date was some machinery with a fair value of €48,000 above its carrying amount. The useful economic life of this machinery at the acquisition date was estimated to be six years. The fair value adjustment has been considered in arriving at the €3 million referred to in note (i), but has not been incorporated into the books of Milhouse.

(v) During the year ended 31 March 2017 Kildome sold goods to Milhouse totalling €36,000. These goods were sold by Kildome at a mark-up of 20% on cost price. The goods were traded evenly throughout the year. €6,000 worth of inventory (at cost to Milhouse) was held by Milhouse at 31 March 2017. These goods were supplied in February and March 2017.

(vi) Since acquisition, Kildome has managed the administration of the entire group. Kildome invoiced Milhouse €10,000 for its share of these costs. Kildome recorded this transaction within "other income", and Milhouse within "operating expenses".

(vii) On 1 February 2017, Flanders sold some land to Kildome for €200,000, recording a profit of €80,000. This profit is included within "other income" in the books of Flanders. Assume this transaction had no taxation impact.

(viii) Kildome has a policy of revaluing property to fair value as permitted under the revaluation model of IAS 16. Neither Milhouse nor Flanders adopts the revaluation model of IAS 16 - *Property, Plant and Equipment*, instead choosing the cost model. If they had adopted the revaluation model, Milhouse would have recorded revaluation gains of €15,000 at 31 March 2017. No revaluations would have been necessary prior to its acquisition.

(ix) Assume all expenses and gains accrue evenly throughout the year unless otherwise instructed.

REQUIREMENT:

(a) Calculate the goodwill arising on the acquisition of Milhouse in accordance with IFRS 3. Calculate the goodwill amount that should appear in the Consolidated Statement of Financial Position of Kildome at 31 March 2017.

(3 marks)

(b) Calculate the goodwill figure that would have been recorded on acquisition of Milhouse had FRS 102 - *The Financial Reporting Standard Applicable in the UK and Republic of Ireland* been used to calculate this instead of IFRS 3. Assume for the purposes of this requirement that the useful economic life of goodwill cannot be determined.

(3 marks)

(c) Prepare a consolidated Statement of Profit or Loss and Other Comprehensive Income for the Kildome Group for year ended 31 March 2017 in accordance with IFRS.

(22 marks)

Presentation marks (2 marks)

[Total: 30 Marks]

2. Leonard Plc is an importer and wholesaler of mobile phone accessories and related goods. Its summarised financial statements for the year ended 31 March 2017 (and 2016 comparatives) are as follows:

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

	2017	**2016**
	€ million	**€ million**
Revenue	275	150
Cost of sales	(100)	(30)
Gross profit	175	120
Operating costs	(50)	(30)
Investment income	12	12
Finance costs	(50)	(15)
Profit (loss) before taxation	87	87
Income tax expense	(10)	(10)
Profit for the year	77	77
Other comprehensive income (amounts that will not be reclassified to profit or loss):		
Fair value gains on equity investments	30	5
Revaluation losses on property plant & equipment	(45)	-
Total comprehensive income (loss) for the year	**62**	**82**

Statements of Financial Position as at 31 March:

	2017	**2016**
	€ million	**€ million**
Assets		
Non-current assets:		
Property, plant and equipment	1,198	677
Intangible asset – franchise	20	-
Equity investments designated “fair value through OCI”	170	140
	1,388	817
Current assets		
Inventory	40	19
Trade receivables	52	28
Bank	40	10
	132	57
Total assets	**1,520**	**874**
Equity and liabilities		
Equity:		
Equity shares of €1 each	180	120
Share premium	60	--
Other components of equity	40	55
Retained earnings	400	350
	680	525
Non-current liabilities:		
Bank loan	750	300
Current liabilities:		
Trade payables	30	9
Other accruals	50	30
Current tax payable	10	10
	90	49
Total equity and liabilities	**1,520**	**874**

On 1 April 2016, the directors of Leonard Plc decided to expand the business by purchasing a franchise to import and distribute additional lines of products. The franchise cost €25 million and had a five-year life. However, it can be renewed at an additional fee, subject to satisfactory performance.

The new business required significant investment in warehouses and distribution vehicles. To finance this expansion, additional shares were issued and the existing bank loan was replaced by a bigger one. The bank charged a higher interest rate on the new loan due to the higher gearing ratio that resulted from the increased debt level. The new capital was raised on 1 April 2016, and the loan is repayable on 31 March 2022.

During a board meeting held to review the year's performance, some of the directors expressed dissatisfaction with the financial results, noting that despite significantly increased revenue, profit for the year posted zero growth, and total comprehensive income decreased by €20 million.

The finance director agreed that there was a disappointing outcome for the year ended March 2017. He presented some information that he felt might be helpful in analysing the cause of the poor results and likely trends in the future performance of the business. He also made the following points:

- In the year ended 31 March 2017 the pre-existing product lines (which excluded the expansion) reported revenue of €175 million, cost of sales of €33 million and operating expenses of €28 million.
- There had been production problems with the manufacturer of some of the new products, leading to a shortage of supply. Leonard Plc had to source product from another supplier at a higher cost to meet contractually agreed deliveries. This added €22 million to cost of sales in the period. These problems have now been resolved and are not expected to recur.
- Dividends of €0.15 per share were paid on 31 March 2017, in accordance with a previous board decision. This was the same amount per share as the previous year.

REQUIREMENT:
Produce a report to review the concerns of the dissatisfied directors using appropriate ratios and the information above. Your report should make recommendations, where appropriate, to address these concerns.

[Total: 30 Marks]

3. **The following multiple-choice question contains 8 sections, each of which is followed by a choice of answers. Only one of the answers offered is correct. Each question carries 2.5 marks. Provide your answer to each section on the answer sheet provided.**

REQUIREMENT:
Provide your answer to each section in the answer sheet provided.

1. On 1 April 2016, Pear Plc entered a three-year finance lease agreement to purchase a vehicle. The vehicle had a cash purchase price of €40,000. The lease required an upfront payment of €10,000, and three annual payments on 31 March 2017, 2018 and 2019 of €12,063.45. The implicit rate of interest is 10% per annum.

   What amount should be presented as the current liability for finance lease obligation at 31 March 2017?

   (a) €20,936.55
   (b) €12,063.45
   (c) €10,966.76
   (d) €9,969.80

2. One of the fundamental qualitative characteristics of financial information identified by the Conceptual Framework is "Faithful Representation". This means that financial reporting must represent faithfully the effect of transactions which occurred during the period on the entity's assets, liabilities, expenses and gains. Which one of the following statements best represents a true example of faithful representation?

   (a) Reporting redeemable preference shares as a liability in the statement of financial position.
   (b) Reporting finance lease payments as expenses in profit or loss.
   (c) Adopting the revaluation model of IAS 16 Property plant & equipment, and applying it selectively to certain assets in a class, and not to others.
   (d) Recording inventory at net realisable value in all cases.

3. On 1 April 2016, Peach Plc purchased a goldmine, and commenced mining operations. A condition of the mining licence is that the site be restored on completion of mining operations. This is estimated to cost €30 million in 8 years. The present value of €30 million on 1 April 2016 is €16.21 million, using a discount rate of 8%. What should be the carrying value of the provision at 31 March 2017 under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*?

   (a) €17.51 million
   (b) €16.21 million
   (c) €3.75 million
   (d) €2.03 million

4. Melon Plc is an Irish company whose functional currency is the Euro. On 31 January 2017, it sold goods to a UK customer at an agreed price of GB£25,000. At the reporting date 31 March 2017, the balance remained payable. The relevant exchange rates were as follows:

   31 Jan 2017: €1 = GB£0.89
   31 March 2017: €1 = GB£0.85

   Ignoring the time value of money, what is the amount of exchange gain or loss that would appear in the financial statements of Melon Plc for year ended 31 March 2017 based on the above transaction?

   (a) €1,321 loss
   (b) €1,321 gain
   (c) €1,000 loss
   (d) €1,000 gain

5. Pineapple Plc bought 70% of the equity shares in Kiwi Plc in 2010, paying a total of €40 million. Goodwill arising on the acquisition was €6 million. On 31 March 2017, Pineapple Plc sold its entire holding in Kiwi Plc for €86 million. The carrying values relevant to Kiwi in the consolidated financial statements at that date were as follows:

Identifiable net assets	€103 million
Goodwill	€6 million
Non-controlling interest	€31 million

How much should be recognised in consolidated profit or loss with respect to the gain or loss on disposal of Kiwi?

(a) €46 million
(b) €9.7 million
(c) €8.0 million
(d) €15 million

6. Grape Plc bought 40% of the equity shares of Plum Plc on 1 April 2016, at a cost of €6.2 million. Grape Plc exerts significant influence over the management of Plum Plc. During the year ended 31 March 2017 Plum Plc reported profit for the year of €2.5 million and other comprehensive income of €500,000. The investment in Plum had a fair value of €7.9 million at 31 March 2017.

What should be the carrying value of the investment in Plum Plc in the consolidated financial statements of Grape Plc on 31 March 2017?

(a) €7.4 million
(b) €6.2 million
(c) €7.9 million
(d) €9.2 million

7. Orange Plc provides the following information in respect of the year ended 31 March 2017:

- Profit before taxation was €30 million.
- Depreciation charged to expenses was €6 million.
- A provision for resolution of a compensation claim of €3 million made in a previous year was released.
- Inventory decreased by €1.6 million.
- Trade payables increased by €2.2 million.

What is the cash generated from operations based on the above information?

(a) €33.6 million
(b) €42.8 million
(c) €36.8 million
(d) €29.2 million

8. The following figures appear in the inventory records of Lemon Plc on 31 March 2017.

Item	**Quantity**	**Cost per unit in €**	**Net Realisable Value per unit in €**
A45116	50 units	30	42
A92310	75 units	40	35

Under IAS 2 *Inventory,* what figure should be reported as inventory in current assets in the statement of financial position as at 31 March 2017?

(a) €4,500
(b) €4,725
(c) €4,125
(d) €5,100

[Total: 20 Marks]

Answer <u>either</u> Question 4 <u>or</u> Question 5

4. IAS 10 *Events After the Reporting Period* sets out guidance for dealing with events which occur after the reporting date but which may have implications for the financial statements up to the reporting date. It distinguishes between adjusting events and non-adjusting events.

Geordie Plc is in the process of finalising its financial statements for year ended 31 March 2017. The draft statements were completed on 14 April 2017, and the audit is currently in progress. The financial statements are expected to be approved by the board of directors on 15 May 2017, and published on 20 May 2017. The following matters have come to light during the audit and your advice is requested. No adjustment has yet been made for any of the following.

(i) Closing inventory at 31 March 2017 includes 100 items carried at cost €5,000 each. New safety regulations were announced on 5 April 2017 with immediate effect. The items of inventory do not comply with these regulations. As a result, the net realisable value of the inventory is only €4,500 each.

(ii) An investment in unquoted equity instruments was held by Geordie Plc at 31 March 2017 at an amount of €3.5 million. This was its fair value on 30 September 2016, the most recent reporting date. Due to the unavailability of professional valuers, an updated fair value was not available until 15 April 2017. On this date, the valuer provided an estimate of fair value of €2.8 million.

(iii) Geordie Plc was being sued on 31 March 2017. At that date the case had been heard, but the judgment was only handed down on 20 April 2017. The outcome was that Geordie was found liable for damages and costs totalling €3.1 million. On 21 April 2017, Geordie filed a claim with its insurers and on 28 April 2017, was notified that the insurer would cover €2.6 million of the loss.

(iv) On 30 March 2017, Geordie paid €500 for a raffle ticket to support a local charity. On 3 April 2017, the company was notified that it had won first prize of €100,000. The draw took place on 31 March 2017.

REQUIREMENT:

(a) Discuss the concepts of "adjusting" and "non-adjusting" events as defined by IAS 10 *Events After the Reporting Period*, and explain the accounting treatment and disclosures required in each case.

(8 marks)

(b) In each case (i) to (iv) above, prepare a briefing note advising on the accounting treatment and / or disclosures required as a result of the event(s) after the reporting date.

(12 marks)

[Total: 20 Marks]

<u>OR</u>

5. IAS 16 *Property Plant and Equipment* sets out the accounting requirements for initial recognition and measurement, subsequent measurement and derecognition of items of property, plant and equipment. IAS 16 expands on and applies the definition of an asset in the Conceptual Framework, as well as the recognition criteria set out in that document.

On 31 December 2016, Stanley Plc completed the construction of a new headquarters building. Some costs associated with this were as follows:

	€'000
Purchase of site	200
Legal costs and stamp duty on site purchase	16
Demolition of existing derelict building on site	18
Design and planning costs	49
Redesign costs due to conditions of planning permission	15
Redesign costs due to errors in the original design	12
Tendering and procurement costs	5
Management time spent on the above, estimated apportionment	22
Construction contractor's fee to builder's finish	754
Rectification costs due to contractor error, not covered by the contractor	13
Completion, painting and furnishing	113
Cost of moving in staff, files and equipment	37
Cancellation costs of operating lease on previous headquarters building	31

The new building was brought into use on 1 January 2017. It was estimated to have a useful economic life of 50 years from that date, and a residual value of €140,000 at the end of its life (excluding the land).

All the above costs were debited to a suspense account and credited to cash. No other entries were made. All items were paid as incurred.

REQUIREMENT:

(a) Outline how a newly constructed building should be recorded in the financial records applying the principles of IAS 16 *Property Plant and Equipment.*

(4 marks)

(b) Recommend how further expenditure on an existing building should be treated under IAS 16 *Property Plant and Equipment?*

(4 marks)

(c) Set out journal entries and supporting calculations to show how the principles of IAS 16 *Property Plant and Equipment* should be applied in accounting for the transactions described above for year ended 31 March 2017.

(12 marks)

[Total: 20 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

CORPORATE REPORTING

PROFESSIONAL 1 EXAMINATION – APRIL 2017

SOLUTION 1

Marking Scheme:

(a)	Goodwill under IFRS	
	Calculation of goodwill on acquisition	2
	Treatment of impairment loss	1
	Subtotal	**3**
(b)	Goodwill under FRS 102	
	Calculation of goodwill on acquisition	2
	Calculation and treatment of amortisation	1
	Subtotal	**3**
(b)	Statement	
	Basic consolidation plan (100% Kildome + 100% Milhouse * 9/12)	4
	Goodwill impairment (inclusion in expenses)	1
	Depreciation on FVA (calculation and inclusion in expenses)	2
	Intra-group revenue and purchases (exclusion)	2
	Unrealised profit on intra-group trading (calculation and elimination)	2
	Administration cost (exclusion from both headings)	2
	Calculation and recognition of share of results of associate (incl adjustments)	4
	Calculation and attribution of results to NCI and owners of parent	4
	Inclusion of Milhouse's revaluation gain in OCI	1
	Presentation	2
	Subtotal	**24**

[Total: 30 Marks]

SUGGESTED SOLUTION

(a)	Calculation of goodwill on acquisition of Milhouse under IFRS:	€'000	€'000
	Cost of investment		2,500
	Fair value of NCI		1,000
	Fair value of net assets at acquisition		(3,000)
	Goodwill		500
	Impairment loss 31 March 2017		(30)
	Recoverable amount 31 March 2017 (to SOFP)		470

(b)	Calculation of goodwill on acquisition of Milhouse under FRS 102:	€'000	€'000
	Cost of investment		2,500
	Value of NCI (3,000 * 30%) Note (i)		900
	Fair value of net assets at acquisition		(3,000)
	Goodwill		400
	Amortisation to 31 March 2017 Note (ii)		(80)
	Balance 31 March 2017 (to SOFP)		320

Note (i): FRS 102 requires the use of the partial method, and does not permit use of the fair value method.
Note (ii): FRS 102 requires annual impairment over the useful economic life of goodwill. If the useful economic life cannot be determined, the life may not exceed five years.

(c) **Kildome plc: Consolidated Statement of Profit or Loss and Other Comprehensive Income**

for year ended 31 March 2017

	(100% Kildome + 100% Milhouse * 9/12)	€ '000
Revenue	3,500 + (760 * 9/12) -27 (vi)	4,043
Cost of Sales	2,000 + (320 * 9/12) +6 (v) -27 + 1 (vi)	(2,220)
Gross Profit		1,823
Operating expenses	210 + (160 * 9/12) + 30(iii) -10 (vii)	(350)
Finance costs	30 + (20 * 9/12)	(45)
Other income	20 -10 (vii)	10
Share of profit for year of associate	Working (iv)	17
Profit before taxation		1,455
Taxation	(150 + (60 * 9/12))	(195)
Profit for the year		1,260
Other comprehensive income (Amounts that will not be reclassified to profit or loss)		
Gains on revaluation of property	(60 + 15 (viii)	75
Total comprehensive income for the year		1,335

Profit for the year attributable to:	
Owners of the parent (balancing figure 1,260 – 49.2)	1,225.8
Non-controlling interest (ii)	34.2
	1,260.0
Total comprehensive income for the year attributable to:	
Owners of the parent (balancing figure 1,335 – 53.7)	1,296.3
Non-controlling interest (ii)	38.7
	1,335.0

Working (i): Group structure:

Kildome plc – Parent

Milhouse plc – 70% ownership interest acquired by Kildome 3 months into the financial year. Hence Milhouse is a subsidiary of Kildome for 9 months of year. Therefore, include 100% of results, time apportioned by 9/12. NCI = 30%.

Flanders plc – 30% ownership interest acquired by Kildome 6 months into the financial year, significant influence exerted. Therefore, Flanders is an associate of the group. Include as single-line adjustments 30% of profit for year, and 30% of other comprehensive income, time apportioned by 6/12.

Working (ii) – non-controlling interest	**Profit €'000**	**TCI €'000**
Milhouse total per SPLOCI given * 9/12	150	150
Less Goodwill impairment loss (iii)	(30)	(30)
Less adjustment for depreciation on FVA (v)	(6)	(6)
Add revaluation gains - Milhouse	-	15
Adjusted figures	114	129
NCI percentage	30%	30%
NCI amount	34.2	38.7

Working (iii) – goodwill impairment

Impairment loss on consolidated goodwill €30,000 included as operating expense in year of recognition. NCI is affected as the fair value method was used to calculate goodwill.

Note: Goodwill may be included in cost of sales for full credit.

Working (iv) – Share of results of associate

Profit for year generated by associate	€360,000
Profit on sale of land included above (note (vii) - occurred on 1 February 2017)	(80,000)
Profit generated across the year	280,000

Kildome's share of profit for year of associate = 280 * 30% * 6/12 = €42,000

Kildone's share of profit on sale of land (80 * 30%)	24,000
Eliminated due to inter-company trading (80 * 30%)	(24,000)
Impairment loss this year in investment in associate (note (iii))	(25,000)
Net income recognized from associate	17,000

NCI is not affected as the associate is owned by the parent.

Tutorial note:
The profit on the sale of land by the associate has two complications:

(1) It occurred during the period Kildome had significant influence. Hence it is not appropriate to time-apportion this gain. It did not accrue evenly over the year.
(2) The gain arises on the sale of the land to Kildome. Hence from a group perspective this gain is unrealized. As normal we eliminate the group's share (30%) of any unrealized gains or losses on trading with an associate. Hence the recognition and elimination cancel each other out (boxed section above).

Working (v) – Fair value adjustment consequences
Additional depreciation not yet charged re fair value adjustment:
€48,000 / 6 years * 9/12 = €6,000
Add to cost of sales expense this year.
NCI is affected as it is Milhouse's asset that is being adjusted.

Working (vi) – intra-group trading
Eliminate the portion intra-group sales and purchases that occurred since acquisition (€36,000 * 9/12 = €27,000) in full from group revenue and group cost of sales.

Unrealised profit provision required = €6,000 * 20/120 = €1,000
Increase Cost of Sales with this amount.

NCI is not affected as Kildome (parent) was the internal selling company that recorded the gain.

Working (vii) – intra-group administration expenses
Eliminate intragroup income and expenses €10,000 from other income and operating expenses.

Working (viii) – harmonization of accounting policies
Add €15,000 to Milhouse's OCI
NCI will share in this gain also.

Tutorial Note:
It is important that all companies being consolidated adopt consistent accounting policies. Hence we must make adjustment to OCI to recognise the revaluation gains of Milhouse. As these gains all occurred after the acquisition date, time apportionment is not applied.

SOLUTION 2

Marking Scheme:

Report
Analysis at appropriate depth (maximum of 12 marks for ratio calculation) **[Total: 30 Marks]**

Ratio calculation

	y/e 31 March 2016	y/e 31 March 2017	2017 adjusted
Gross margin	120/150 = 80%	175/275 = 63.6%	(175+22)/275 = 71.6%
Net margin	102/150 = 68%	137/275 = 49.8%	(137+22)/275 = 57.8%
ROCE	102/(525+300) = 12.4%	137/(750+680) = 9.6%	(137+22)/(750+680) = 11.1%
ROE	77/525 = 14.7%	77/680 = 11.3%	(77+22-2.5)/680 = 14.2%
Current ratio	57:49 = 1.16:1	132:90 = 1.47:1	n/a (no change)
Acid Test	(57-19):49 = 0.78:1	(132-40):90 = 1.02:1	n/a
Inventory days	19/30*365 = 231 days	40/100*365 = 146	40/(100-22)/365 = 187
Receivables days	28/150 * 365 = 68 days	52/275 * 365 = 69	n/a
Payables days	9/30*365 = 109 days	30/100*365 = 109	30/(100-22)*365 = 140
Gearing Ratio	300/525 = 57%	750/680 = 110%	750/(680+22-2.5) = 107%

Report:
To: Directors of Leonard plc
From: P. Frogger, Accountant
Re: Analysis of performance of Leonard plc for year ended 31 March 2017.
Date: 30 April 2017.

Dear Directors,
I am pleased to present to you my report into the performance of your company for the past year. I have taken the liberty of making comparisons with the previous year, and tentative projections, based on information provided by yourselves.

I will address performance under the following headings, which are customary for this type of report. These are:
Profitability;
Liquidity; and
Efficiency.

Calculations and supporting data are provided in an appendix to this report, should you wish to refer to them.

Profitability
The first point that should be made is that Leonard plc is highly profitable under almost all standard measures.

Gross margin and net margin are exceptionally high, and should the business grow as projected, will lead to very fast growing profits. Gross margins were 80% in 2016, falling to a still excellent 64% in 2017. Allowing for the unusual cost incurred in 2017, and assuming this had not happened, the gross margin would have been close to 72%. Whilst this is a decrease from the 2016 figure, it should be noted that high volumes at a 72% margin will lead to more profit that lower volumes at an 80% margin. Hence it is not a bad thing to see the margin drop somewhat as volumes increase, provided the additional profit outweighs the lower margin. Whilst this did not happen in 2017, it is reasonable to project that this will happen going forward, as set-up issues get resolved and volumes continue their expected growth.

Return on capital employed is reasonable, although not exciting. It seems from the nature of your business, and from discussions with your finance director, that significant capacity now exists to leverage the existing capital base, and grow sales volume substantially. This will lead to growth in the return on capital.

Return on equity is higher than ROCE, suggesting that your business is using borrowed funds effectively to leverage equity. This effect should only increase as the business scales up.

Liquidity
The liquidity of Leonard plc has improved significantly over the past year.

The current ratio improved from 1.16:1 to 1.47:1. The Acid Test (Quick) ratio likewise improved from 0.78:1 to 1.02:1. These changes transform the ratios from being worryingly low in 2016 to their present improved levels.

This change is mainly due to the capital raised which contributed €570m to company funds. Much of this was invested in future expansion, but whilst many business see a liquidity crunch when expanding, you appear to have managed this very well.

Longer term liquidity is measured by the Gearing ratio. This was very conservative in 2016, at 57%. The ratio (on a debt/equity basis) extended to 110% in 2017, due to additional debt taken on to fund the expansion. This appears to have led to an increased interest rate. The 2016 debt incurred interest at 5% (15/300) whilst the 2017 debt was charged at 6.7% (50/750). This means the marginal debt in incurring a marginal interest rate of 7.8% (50-15) / (750-300) per annum. This appears justified given the strength of the market opportunity opening to you. However, be aware that return on capital needs to exceed this rate or else the business will start hemorrhaging cash. This can turn into a vicious circle very easily. Note carefully the date the loan is due for repayment or renegotiation (2022). This can create a liquidity trap unless the business performs as projected in the meantime.

Overall, there seems to be little liquidity pressure on this company. There is ample cash to pay short-term liabilities as they fall due.

Efficiency
This is an area I recommend that some close attention be paid to. There seems to be some weaknesses in the management of working capital.

Inventory days appear to be high, although they are improving. This may be due to the long shipping times inherent in your business model. However, I recommend examining this to see if improvements can be made.

This does appear to be compensated for somewhat by longer payables days. If goods are spending a long time on ships, and yet your firm has not paid for them, this is cash neutral. It may be worth checking if the price paid would be cheaper if goods were paid for more quickly. Thre is often a hidden costs to long payables days, in that a higher price than necessary may be charged by suppliers.

Receivables days, likewise, look as if tighter management would benefit the business. 68-69 days is longer than normal to be allowing customers to pay for goods purchased. The nature of the product is such that it may become obsolete quite quickly. If this happened, customers may struggle to pay for goods that are no longer selling for them. As gross margins are so high, there may be scope to offer customers a discount for quicker payment. This would pay for itself in lower interest and lower bad debt costs.

Outlook for the future
Although profit for 2017 was the same as 2016 despite greater volumes, this is not a concern to me. On examining your figures, it seems clear that there were one-off items affecting performance in 2017 that will not recur. I have recalculated the key ratios on the basis that the €22 million in extra purchase costs will not recur in 2018. The revised ratios show a much more positive performance. I have assumed that €22 million would be saved, as instructed, and that this would be taxed at the company's average rate of 11%.

Looking forward to 2018, if sales volumes achieve 20% growth as predicted, profit for the year could be reasonable expected to reach €121 million. This is a full 57% ahead of the 2017 performance. This would place Leonard plc on a very strong financial footing. If this growth rate can be maintained, I foresee a very bright future indeed.

Conclusion
Should you have any further questions please feel free to contact me at any time.

SOLUTION 3

Marking Scheme:
8 parts * 2.5 mark each **[Total: 20 Marks]**

SUGGESTED SOLUTION:

Part 1: Answer **(d)**
The current liability is that portion of the liability recognized at 31 March 2017 that is payable within 12 months of the reporting date. Hence:

Total payment due within 12 months (31 March 2018)	€12,063.45
Interest yet to be accrued included in this amount *	(2,093.65)
Capital sum payable in 1 year	9,969.80

* Note:
Interest to be accrued in the next 12 months to 31 March 2018 is 10% of the total liability at 31 March 2017. This is calculated as follows:

Initial lease liability	€40,000
Less up front payment	(10,000)
Effective opening liability 1 April 2016	30,000
Finance cost to 31 March 2017 (@10%)	3,000
Payment 31 March 2017	(12,063.45)
Total lease liability 31 March 2017	20,936.55
Finance cost (interest) to 31 March 2018 (@ 10%)	2,093.65

Part 2: Answer **(a)**
Transactions are to be reported in accordance with their substance. Redeemable preference shares represent an obligation to repay the money at some stage, hence should be reported as liabilities.

The other statements are violations of applicable accounting standards, hence do not represent examples of faithful representation except potentially in exceptionally rare circumstances.

Part 3: Answer **(a)**
The provision should be recognized at 1 April 2016 at its present value, or €16.21 million. By 31 March 2017, 1 year has passed, so the provision should be increased by 8%, representing the unwinding of 1-year's discount. The difference should be charged to finance costs in profit or loss.

An alternative method would be to discount the expected cost of €30 million by 7 years, to reflect the new reporting date. The same answer would result.

Part 4: Answer **(b)**

Trade receivables a/c

	€		€
Revenue	28,090	Profit or loss (gain)	1,321
		Balance c/d	29,412
	28,090		28,090

31 Jan 2017:
GB£ 25,000 / 0.89 = € 28,090
This is recorded as trade receivables and revenue.

Balance 31 March 2017:
GB£ 25,000 / 0.85 = €29,412
This remains receivable, and under IAS 21 should be remeasured as it is a monetary item.

The balancing figure is the overall gain or loss. It is a gain here, as we are owed more than was originally recorded.

Part 5: Answer **(c)**

Group gain (loss) on disposal is calculated as follows:		
Proceeds		86 million
Less carrying value of assets sold:		
Identifiable net assets (100%)	103m	
Goodwill	6m	
Less NCI share in the above (30%)	(31m)	
Carrying value of Pineapple's share		78 million
Gain on disposal		8 million

Tutorial notes:
Identifiable assets do not include goodwill. Goodwill is an asset of the subsidiary, and should be included at its carrying value.

The parent's share of the new assets and goodwill is not necessarily 70% of the total. NCI represents the carrying value of the ownership interest that is not the parent's, hence the parent's ownership is calculated as the total less the NCI share.

The NCI share may not be proportional to the shareholding for three possible reasons:
(1) If goodwill at acquisition is measured using the proportion of net assets method, the NCI will not share in any of the goodwill value.
(2) If goodwill at acquisition is measured using the fair value method, the portion attributable to the NCI is often not proportional to their share of the voting equity.
(3) There may be ownership interests not represented by voting equity, such as preference shares.

Part 6: Answer **(a)**

Investment in Associate:	€m
Cost	6.2
Share of profit for year (2.5 * 40%)	1.0
Share of OCI (0.5 * 40%)	0.2
Total	7.4

Part 7: Answer **(c)**

	€m
Profit before tax	30
Depreciation	6
Decrease in provision	(3)
Decrease in inventory	1.6
Increase in trade payables	2.2
Cash flow generated	36.8

Part 8: Answer **(c)**

Inventory should be recorded at the lower of cost and net realizable value, taking each line of goods separately.

Hence:

Item	Quantity	Cost per unit in €	Net Realisable Value per unit in €	SOFP Value in €
A45116	50	30	42	1,500
A92310	75	40	35	2,625
Total				4,125

SOLUTION 4

Marking Scheme:

(a)	Explanation of the term "Events after Reporting Date"	2
	Definition of the period such events are to be considered	2
	Accounting treatment and disclosures for adjusting events	2
	Accounting treatment and disclosures for non-adjusting events	2
	Subtotal	8
(b)	4 parts at 3 marks each	12
	Subtotal	12

[Total: 20 Marks]

SUGGESTED SOLUTION

(a) It is normal that financial statements take some time after the year-end to be finalised, audited and approved for issue by the board of directors. Events after the reporting date are those events, favourable and unfavourable, that occur between the reporting date and the date when the financial statements are authorised for issue.

Adjusting event:
An adjusting event is an event which provides further evidence of a condition existing at the reporting date. An entity shall adjust the amounts recognised in its financial statements for the period just ended to reflect adjusting events after the reporting period.

Non-adjusting event:
An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting date. In this case, there was no condition existing at the reporting date, so no adjustment should be made.

Disclosures should be made in the financial statements of significant non-adjusting events after the reporting date.

If a non-adjusting event means the going concern concept no longer applies to the entity, the event should be treated as an adjusting event, and the financial statements should not be prepared on a going concern basis.

(b)

(i) It would appear that the event causing the loss in value only occurred after the reporting date. There was no condition existing at the reporting date. Had we sold the goods at the reporting date we would have obtained full price for them. Hence this is a non-adjusting event. If the loss is material, disclosure of the event should be made in the notes to the financial statements.

(ii) Unless it is clear that a particular event between 31 March and 15 April 2017 caused the drop in the value of this investment, it should be assumed that the investment had in fact lost value on 31 March 2017, and the subsequent valuation only provided evidence of this. Hence, the receipt of the valuation is an adjusting event, and the investment should be written down at the reporting date.

(iii) The liability existed at the reporting date, but confirmation of the amount was only received on 20 April 2017. This is an adjusting event, and the treatment of this item in the financial statements (assuming a nil payment) should be amended to reflect the information received subsequently. Accordingly, provision should be made for the entire amount of the judgment. The filing of the insurance claim only took place following the reporting date, hence no account should be taken of this at 31 March 2017. As confirmation of the success of the claim was received prior to the signing off date, this should be disclosed in the notes.

(iv) The prize was actually won before the reporting date. Hence the financial statements should reflect this even though the notification only arrived on 3 April. This is an adjusting event.

SOLUTION 5

Marking Scheme:

(a)	Recording a new building in the financial statements	
	any 4 valid points @ 1 mark each	4
	Subtotal	4
(b)	Accounting for subsequent expenditure on an existing building	
	any 4 valid points @ 1 mark each	4
	Subtotal	4
(c)	Capitalisation and expensing of correct items	6
	Journal entry to record all costs incurred and correct existing entry	2
	Calculation of correct depreciation charge for the period, and journal entry to record same.	4
	Subtotal	12

[Total: 20 Marks]

SUGGESTED SOLUTION:

(a) Definition:

The term "property, plant and equipment" includes tangible items that:

- Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- Are expected to be used during more than one period.

Recognition of a non-current asset:

An item of Property, Plant or Equipment should be recognised in the books if:

- It is probable that the economic benefits derived from the item will flow to the business AND
- The cost / value can be measured with reliability.

Cost of a non-current asset includes:

- Purchase price, including import duties and non-refundable purchase taxes
- Incidental costs of acquisition – any cost directly attributable to bringing the asset to the location and condition necessary for it to be brought into productive use. Examples: Delivery, Installation, Legal & Professional Fees.
- Finance costs (only those incurred up until the asset is substantially ready for use) must be capitalised under IAS 23 (see later).
- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, if the entity has, at the time of purchase, an obligation to incur such expenditure.
- The capitalised cost of any asset cannot exceed its recoverable amount.
- The term "capitalise" means that the amount in question is recorded as an asset. The opposite of "capitalise" is to "write off as an expense", in which case the amount in question is recorded as an expense in the SPLOCI. Although both are debit entries, it is important to choose the correct class of account – asset or expense. The credit entry remains the same regardless.

(b) Subsequent expenditure

Such expenditure should usually be written off to profit or loss as incurred. If, however, an obligation exists to incur further expenditure of a capital nature, then this should be capitalised also. Subsequent commitments entered into should be capitalised in three circumstances:

- o If subsequent expenditure enhances the economic benefits to be derived from the asset in excess of the previously assessed standard of performance,
- o Where a component of an asset treated separately for depreciation purposes is replaced,
- o Where the expenditure relates to a major inspection or overhaul which restores economic benefits consumed by the entity and already charged as depreciation.

(c) The following amounts should be capitalised, as they appear to be directly attributable to bringing the asset into a condition in which it is ready for use:

	€'000
Purchase of site	200
Legal costs and stamp duty on site purchase	16
Demolition of existing derelict building on site	18
Design and planning costs	49
Redesign costs due to conditions of planning permission	15
Tendering and procurement costs	5
Construction contractor's fee to builder's finish	754
Completion, painting and furnishing	113
Total	1,170

The following amounts should be expensed:

	€'000
Redesign costs due to errors in the original design	12
Management time spent on the above, estimated apportionment	22
Rectification costs due to contractor error, not covered by the contractor	13
Cost of moving in staff, files and equipment	37
Cancellation costs of operating lease on previous headquarters building	31
Total	115

Reasons:

- Costs due to error do not add to the economic value of an asset. They are effectively wastage, and should be expensed as incurred.
- Apportionment of management time are indirect costs. They are not "directly attributable" to the construction.
- Costs of moving in are not necessary to bring the asset into a location or condition where it is ready for use.
- Cancellation costs on an old building have nothing to do with a new building. They do not add any value to the economic benefits derived from the new building.

Hence the journal entry required to record the new building at 31 December 2017 is as follows:

	DR €'000	**CR €'000**
Dr Property, plant & equipment	1,170	
Dr profit or loss	115	
Cr Suspense		1,285

As the building is ready for use 3 months prior to the reporting date, 3 month's depreciation should be provided.

Depreciable amount:	**€'000**
Total capitalised cost	1,170
Less land component (200+16+18)	(234)
Less residual value	(140)
Depreciable amount	796
Annual depreciation charge (796 / 50 years)	15.92
Charge for three months	3.98

Hence the journal entry required to record depreciation of the new building at 31 March 2017 is as follows:

	DR €'000	**CR €'000**
Dr Profit or loss	3.98	
Cr Accumulated Depreciation PPE		3.98