CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

ADVANCED CORPORATE REPORTING

PROFESSIONAL 2 EXAMINATION - APRIL 2018

NOTES:

You are required to answer **ALL** Questions.

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 **20 minutes** to read the paper.

Examination Format

This is an open book examination. Hard copy material may be consulted during this examination, subject to the limitations advised on the Institute's website.

Reading Time

During the reading time you may write notes on the examination paper but you may not commence writing in your answer booklet.

Marks

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

Answers

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.

Answer Booklets

List on the cover of each answer booklet, in the space provided, the number of each question attempted. Additional instructions are shown on the front cover of each answer booklet.

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

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Time Allowed: 3.5 hours, plus **20 minutes** to read the paper. You are required to answer **ALL** questions.

If you make an assumption in any question, please state your assumption clearly.

Case Study

You have recently been appointed as financial accountant at Doddergate Ltd. (Doddergate) which began as a Scandinavian business. However, ten years ago the company moved its operations and established in Ireland. The company manufactures external hard drives and operates in a sector where the rate of technological change rapidly renders products obsolete. To ensure its products remain competitive, the company undertakes significant research and development activities. In addition, in the recent past, it has acquired young companies with promising research and development projects.

The managing director of Doddergate is Jan Kroes. Today is your first day in your new position and you've been asked to attend a welcome meeting in Jan's office. Jan begins the meeting *"Welcome to Doddergate. As I'm sure you've noticed, we're a vibrant and focused company. We have to be: we operate in a sector where only the strongest survive. We might double in size next year or we might be out of business."*

He continues, *"I'm glad you were able to commence your role as financial accountant so soon. The previous accountant quit without notice and it has left us in a difficult situation. Your predecessor left on bad terms and you won't be able to contact her to assist with your transition. The company's financial statements for the financial year ended 31 December 2017 are in draft form and there are a number of outstanding accounting issues which need to be resolved. I will send you an email later this afternoon outlining these issues. We prepare our financial statements using International Financial Reporting Standards (IFRS). The company is taxed at a corporate tax rate of 12.5%."*

You begin to realise that your first day is going to be busy. Before you leave Jan's office, he says *"Doddergate has a long-term loan with a well-known bank. Unfortunately, the loan was extended in 2009 during the financial crisis and the bank included strict covenants in the loan agreement. If we breach the covenants, the entire loan falls due immediately. Doddergate is not in a financial position to pay back the loan in full. We will meet the requirements of the loan covenants based on the current figures in the draft financial statements. However, the outstanding accounting issues that you will be addressing will inevitably change the current draft figures. I will attach extracts from the loan agreement in my email. I want you to outline the implications of each of the accounting adjustments that you recommend for the loan covenants. In addition, I would prefer if you would avoid recommending any accounting treatment that increases the likelihood of breaching our loan covenants. The previous accountant was unable to see the bigger picture and refused to play a part in keeping the company in business. I hope you're different."*

The meeting concludes and you make your way to your new office. You log in to your work email account and see an email, copied below, from Jan:

To: **Financial Accountant (accounts@doddergate.com)**
From: **Jan Kroes (j.kroes@doddgergate.com)**
Subject: **Outstanding accounting issues**

Good day,

As discussed this morning, below are the outstanding accounting issues:

1. Acquisition of SubHat Ltd.

Doddergate has acquired several subsidiaries over the last number of years. Typically the company acquires full ownership of the subsidiaries and has written off all Goodwill associated with the acquisitions in prior years. The financial statements of the subsidiaries for the financial year ended 31 December 2017 have been correctly consolidated in the financial statements for Doddergate Group (outlined in Attachment 1) except for a subsidiary called SubHat Ltd.

Doddergate acquired a start-up company called SubHat Ltd. two years ago (on 1 January 2016). The accountants at SubHat experienced a problem with their accounting system and were able to provide only the financial statements for the 2017 financial year in the last couple of days. As a result, SubHat's financial statements have not yet been consolidated into the group accounts. Doddergate Group's draft financial statements (excluding SubHat) and SubHat's financial statements are included in Attachment 1.

Background information on SubHat:

- Doddergate acquired 80% of the share capital of SubHat on 1 January 2016 when the retained profit of SubHat Ltd had a balance of €80,000. SubHat has not undertaken any share issues or buybacks since the acquisition. All of the tangible assets and liabilities of SubHat were considered to be fairly valued at the date of acquisition.

- On 2 January 2016, SubHat sold an item of plant to Doddergate for €50,000. The plant had originally cost SubHat €40,000, and accumulated depreciation of €10,000 had been provided by SubHat to the date of sale. Doddergate considered the plant to have a remaining useful life of 10 years at the date of purchase and depreciation is being provided on the straight-line basis.

- During the 2017 financial year, Doddergate started supplying certain inventory to SubHat, which it marks up by 20%. Included in SubHat's inventory at 31 December 2017 is €120,000 of such inventory.

- The consolidated retained profit at 1 January 2017 was €850,000 for Doddergate Group (excluding SubHat) and the retained profit for SubHat was €110,000 at the same date.

- No dividends were proposed or declared by either Doddergate or SubHat during the periods under review.

2. Warranty issue

During the financial year to 31 December 2017, a circuit board in the humidity control system at Doddergate's main factory overheated and stopped functioning. The fault was only discovered after five days had passed. During this five-day period, 2,000 external hard drives were manufactured and sold to retailers. The humidity in the factory caused the hard drives manufactured during this period to become faulty. 1,000 of the faulty units have been returned to date. At the end of the 2017 financial year, the sales manager estimated that there will probably be a further 850 returns directly associated with the fault.

Approximately half of the faulty hard drives can be repaired but the other half will have to be replaced with a new unit. It costs €65 to repair the fault, while manufacturing costs for a new unit total €115. Further, it will cost €15 per unit in postage costs to return the units to customers.

The hard drive returns received during the 2017 financial year were repaired, replaced and returned to customers by the 31 December 2017. The hard drive returns received up until the 31 December 2017 and associated costs have been accounted for correctly. However, Doddergate has not accounted for the faulty units that are expected to be returned by customers after the reporting date.

3. Share options to directors

Doddergate issued share options to its directors on 1 January 2017. The options have a vesting period of 10 years and had a fair value of €200,000 on the date of issue. To be eligible to exercise the share options, employees are required to remain continuously employed by Doddergate over the entire vesting period. Actuaries have estimated that 20% of the directors who have received share options will leave the employment of Doddergate over the vesting period.

The options have no financial implications for the next 10 years, so no amounts have been recognised in relation to the share options in the financial statements for the 2017 financial year.

4. Capitalised research expenditure

When Doddergate moved its operations and established in Dublin, we decided to prepare our financial statements using International Financial Reporting Standards (IFRS) for the first time. Last week, I received a query from our auditors about an intangible asset that has remained capitalised on our balance sheet for a number of years.

The accounting standards we applied previously allowed us to capitalise early-stage research expenditure on our statement of financial position. The capitalised research expenditure totals €800,000. The expenditure has remained on the balance sheet since we transitioned to IFRS and has not been amortised since. I'm not sure how the research expenditure should have been accounted for and what the accounting implications are for our group financial statements."

5. **Issue of bonds**

On 1 January 2017, Doddergate issued 10,000 bond instruments with a face value of €100, at a market price of €95. Bond brokers charged fees totalling €18,000 in relation to the bond issue. The bonds carry a coupon rate of 5% and are redeemable in 3 years at face value. Doddergate wishes to account for the bonds using the IFRS 9 - *Financial Instruments* amortised cost method. However, there was some confusion about how the bonds should be accounted for. Currently, the cash received from the bond issue of €950,000 has been recognised as a non-current liability The broker fees of €18,000 were deducted from the non-current liability carrying amount, the coupon payment of €50,000 has been expensed in arriving at profit before tax and the effective rate of interest is 7.62%.

6. **Construction of purpose-built machine**

Doddergate commenced the construction of a purpose-built machine in the company's main factory on 1 March 2017. The machine will be used to manufacture hard drives and will significantly increase the factory's production capacity. The directly attributable costs related to the construction of the machine were incurred as follows:

1 March 2017 - €200,000
1 October 2017 - €200,000

The construction of the machine was suspended from 1 June to 31 July 2017 as the engineering company experienced a labour dispute with their team of engineers. The machine was completed on 1st December 2017. The directly attributable costs listed above have been correctly accounted for.

Doddergate raised a long-term loan of €500,000 on 1 January 2017 to cover the cost of the machine. The loan incurs interest at 6% per annum. The company was able to place excess funds in a short-term deposit account and earn interest of 1% per annum. We have recognised the interest costs and income in the profit or loss for the 2017 financial year. I'm not sure if there are alternative ways to account for the borrowing costs involved with the construction of the machine.

7. **Board appointment with supplier**

In February 2017, I was appointed as the non-executive Chairman of VoltEizzer Technologies Ltd. VoltEizzer supplies Doddergate with raw materials that are used in the production of our hard drives. During the 2017 financial year, sales by VoltEizzer to Doddergate totalled €324,000. At the end of the year, the amount outstanding to VoltEizzer in relation to these sales was €54,000. In addition, I was paid a salary for my role as Chairman of €100,000 by VoltEizzer. Each of these transactions has been correctly accounted for in the financial statements of Doddergate and VoltEizzer. However, I'm not sure if we need to consider any adjustments or additional disclosures due to the relationship between myself, Doddergate and VoltEizzer.

Finally, I have attached extracts from the loan agreement with Doddergate's bank in Attachment 2. The extracts detail the loan covenants which we must adhere to.

Regards,

Jan

Attachment 1:

The following are the summarised financial statements of Doddergate Group (excluding SubHat) and its subsidiary, SubHat Ltd, at the 31 December 2017:

Statement of Financial Position as at 31 December 2017

	Doddergate Group (exc SubHat Ltd)	**SubHat Ltd**
ASSETS	**€**	**€**
Non-Current Assets		
Plant	1,200,000	352,000
- Cost	2,400,000	462,000
- Accumulated depreciation	(1,200,000)	(110,000)
Intangible assets (research & development)	2,000,000	
Investment in SubHat Ltd (160,000 shares)	150,000	
	3,350,000	352,000
Current Assets		
Inventory	820,000	348,000
Trade receivables	710,000	54,000
Cash & cash equivalents	1,500,000	16,000
	3,030,000	418,000
TOTAL ASSETS	**6,380,000**	**770,000**
EQUITY & LIABILITIES		
Equity		
Share capital (€1 shares)	1,000,000	200,000
Consolidated retained profit / Retained profit	2,450,000	142,000
Non-controlling interest	120,000	-
	3,570,000	342,000
Non-Current Liabilities		
Long-term loan	1,518,000	420,000
Bond instruments	932,000	
Deferred tax	40,000	5,800
	2,490,000	425,800
Current Liabilities		
Trade payables	320,000	2,200
TOTAL EQUITY & LIABILITIES	**6,380,000**	**770,000**

Statement of Profit or Loss and Other Comprehensive Income for year ended 31 December 2017

	€	€
Profit before tax	1,808,000	36,160
Taxation	(208,000)	(4,160)
Profit for the year	1,600,000	32,000
Profit attributable to:		
Equity holders of parent	1,600,000	

Attachment 2 - Extracts from loan agreement with Doddergate's bank

Any outstanding loan amounts are due immediately and in full if Doddergate Limited breaches any of the financial requirements listed below. The calculation of the financial metrics below will be based on the information published in the company's audited annual reports during the loan term.

Ratio	**Requirement**
Long-term interest-bearing debt to total equity	Will not exceed 0.70 (70%)
Long-term interest-bearing debt to total assets	Will not exceed 0.40 (40%)

REQUIREMENT:

1. Using Doddergate Group and SubHats' financial statements in Attachment 1, prepare a draft Consolidated Statement of Profit or Loss and Other Comprehensive Income, Statement of Changes in Equity and Statement of Financial Position for Doddergate Group for the financial year ended 31 December 2017.

NOTE: In answering Question 1 you may ignore any adjustments for notes 2 to 7 as provided in the above case.

(30 marks)

2. Write a memo to Jan Kroes addressing the following:

Discuss and justify the necessary accounting treatment for each of the outstanding accounting issues (2) – (7) relating to Doddergate Limited. You should provide journal entries, where appropriate.

(40 marks)

3. Analyse the implications of any accounting adjustments that you have recommended in Question 2 above for Doddergate Group's loan covenants.

(15 marks)

4. Assess the main ethical issues arising in the case study and suggest appropriate safeguards or courses of action to resolve such issues.

(15 marks)

[Total: 100 Marks]

SUGGESTED SOLUTIONS

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PROFESSIONAL 2 EXAMINATION - APRIL 2018

SOLUTION 1

Doddergate Group
Consolidated Statement of Profit or Loss or Other Comprehensive Income
for Year Ended 31st December 2017

	€	
Profit before taxation	1,826,160	W2
Taxation	(209,910)	W3
Profit for Year	1,616,250	
Attributable to:		
Equity holders of the parent	1,609,500	bal fig
NCI	6,750	W1

Doddergate Group
Consolidated SOCIE for Year Ended 31st December 2017

	Share Capital	Retained Profit		NCI		Total
Opening Balance	1,000,000	935,400	W4	178,850	W1	58,850
Profit for Year		1,609,500Per	SOPL	6,750	W1	1,616,250
Closing Balance	1,000,000	2,544,900		185,600		1,675,100

Doddergate Group
Consolidated SOFP as at 31st December 2017

ASSETS	**Workings**	**€**
Non-Current Assets		
- Cost	2,400,000+462,000-10,000	2,852,000
- Accumulated Depreciation	-1,200,000-110,000-10,000+2,000+2,000	(1,316,000)
Plant		1,536,000
Intangible assets		2,000,000
Investment in SubHow	150,000-150,000	
Deferred Tax Asset	+2,500+2,500	5,000
Current Assets		
Inventory	+820,000+348,000-20,000	1,148,000
Trade & Other Receivables	+710,000+54,000	764,000
Cash & Cash Equivalents	+1,500,000+16,000	1,516,000
		3,428,000
Total Assets		6,969,000
EQUITY & LIABILITIES		
Share Capital	+1,000,000+200,000-200,000	1,000,000
Retained Profit	Per SOCIE	2,544,900
Parent Shareholders' Equity		3,544,900
Non-controlling interest	120,000+56,000+2,850+6,750	185,600
Total Shareholders' Equity		3,730,500
Long-term Loan	+2,450,000+420,000	2,870,000
Deferred Tax Liability	+40,000+5,800+250+250	46,300
Trade & Other Payables	+320,000+2,200	322,200
		6,969,000

Workings:

W1 – Equity of SubHat

	TOTAL €	80%		NCI 20%	
At Acquisition:					
Share Capital	200,000				
Retained Profit	80,000				
	280,000	224,000		56,000	
Cost of control		150,000			
Negative Goodwill		(74,000)	Ret Prof		
To 1-1-2017:	€				
Retained Profit – 1.1.17 (given in question)	110,000				
Retained Profit – At Acq	(80,000)				
	30,000				
Profit on Plant (50,000 – [40,000-10,000])	(20,000)				
Deferred Tax on profit (20,000 x 12.5%)	2,500				
Depreciation Adj (20,000 / 10 years)	2,000				
Deferred Tax on depreciation (2,000 x 12.5%)	(250)				
	14,250	11,400	Ret Prof	2,850	
Current Year (1-1-2017 to 31-12-2017):	€				
Profit after tax	32,000				
Depreciation Adj (20,000 / 10 years)	2,000				
Deferred Tax on depreciation (2,000 x 12.5%)	(250)				
	33,750	27,000		6,750	NCI (SOPL)
		112,400	Ret Profit	65,600	NCI (SOFP)

W2 – Consolidated profit before tax:

	€
Doddergate	1,808,000
SubHow	36,160
Depreciation Adj	2,000
Inventory Adj	(20,000)
	1,826,160

W3 – Consolidated taxation:

	€
Doddergate	208,000
SubHow	4,160
Depreciation Adj (2,000 x 12.5%)	250
Inventory Adj (20,000 x 12.5%)	(2,500)
	209,910

W4 – Consolidated retained profit (beginning of year – at 1.1.2017):

	€	
Doddergate	850,000	Given in question but could also have been calculated.
SubHow	85,400	See W1: 74,000 (negative g/w) + 11,400 (RP to BOY)
	935,400	

[30 marks]

SOLUTION 2

Memorandum: Confidential
To: Jan Kroes
From: Name Surname
Subject: Draft financial statements 2017 – outstanding issues
Date: xx/xx/xxx

Issue 2: **[8 marks]**

The applicable accounting standards are IAS 10 Events After the Reporting Period and IAS 37 Provisions, Contingent Liabilities and Contingent Assets. Students may also reference IAS 12 Income Taxes as there are deferred tax implications resulting from the recognition of a provision.

The financial statements of Doddergate Group are in draft form and have not yet been approved at a general meeting of the company. IAS 10 Events After the Reporting Period differentiates between adjusting and non-adjusting events. The manufacturing issue which created the fault occurred in 2017. The faulty hard drives were manufactured and sold to customers during 2017. The facts of the case suggest that the outstanding faulty hard drives and potential cost of returns is a condition that existed at the reporting date (31st December 2017), therefore the event is an adjusting event. The company should apply the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets to determine if it is necessary to recognise a provision for the costs associated with the unreturned hard drives. If a provision is to be recognised, the company should adjust Doddergate Group's financial statements for year ended 31st December 2017 for the provision.

Under IAS 37, Doddergate should recognise a provision for the warranty costs associated with the faulty, unreturned hard drives as the three criteria are met:

(i) A legal obligation exists.
(ii) It is probable that an outflow of economic benefits will arise.
(iii) A reliable estimate of the cost can be made.

An attempt should be made to use the costing information provided in the case study to calculate a reasonable amount to measure the provision at:

Expected future returns:	850 units
Estimated cost of repairs:	425 units x (€65 + €15) = €34,000
Estimated cost of replacements:	425 units x (€115 + €15) = €55,250
Est amount to be provided for:	€34,000 + €55,250 = €89,250

The journal entries to account for the provision are as follows:

		€	€
Dr	Cost of sales (P&L)	89,250	
Cr	Provision account (SOFP)		89,250

The creation of a provision gives rise to a deductible temporary difference. A deferred tax asset should be created under the requirements of IAS 12 Income Taxes:

		€	€
Dr	Deferred tax asset (SOFP)	11,156	
Cr	Tax - deferred (P&L)		11,156
	€89,250 x 12.5% = €11,156		

Issue 3: **[5 marks]**

The applicable standard is IFRS 2 – *Share Based Payments*. IFRS 2 requires the fair value of an equity-settled shared-based payment scheme to be expensed over the vesting period.

Therefore, the fair value of the share options (€200,000) must be expensed over the vesting period of 10 years. However, only 80% of Doddergate's employees are expected to satisfy the vesting conditions at the end of the 10 year period.

The expense to be recognised in the 2017 financial statements will be (€200,000 x 80%) / 10 = €16,000.

The following journal entry is required:

Dr	Share option expense (P&L)	€16,000	
Cr	Equity		€16,000

Issue 4: **[7 marks]**

Answer should attempt to resolve the accounting issue with a reasonable argument. The answer may include a discussion of the following:

The key applicable standard is IFRS 1 (First Time Adoption of International Financial Reporting Standards (IFRS)). IFRS 1 requires the preparer to apply the applicable IFRSs to the recognition and measurement of the reported assets and liabilities in the opening statement of financial position, in the first year of IFRS adoption. As such, the preparer is required to derecognise any assets or liabilities that were recognised under previously-applied accounting standards if they do not qualify for recognition under IFRS.

Doddergate had incurred and capitalised €800,000 of early-stage research expenditure under the company's previously-applied accounting standards. In the first year of transitioning to IFRS, the company should have derecognised this asset from the statement of financial position because the capitalisation of research expenditure is not permitted under IAS 38 (Intangible Assets).

Any accounting adjustments, when converting the opening statement of financial position from the requirements of the previously-applied accounting standards to IFRS, arise from events and transactions that occurred before the date of transition. IFRS 1 requires the preparer to recognise these adjustments directly in equity (this will typically be retained earnings) at the date of transition to IFRS. Therefore, the capitalised research expenditure of €800,000 should have been written off to equity ten years ago when Doddergate first transitioned to IFRS.

IAS 8 - *Accounting Policies, Changes in Accounting Estimates and Errors,* can be used to account for the issue once it has been discovered as a prior period error. A prior period error (PPE) is defined as an omission from, or misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that: (1) was available when the financial statements for those periods were authorised for issue and (2) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Under IAS 8, a material PPE requires retrospective restatement. The preparer must restate: (1) opening balances of assets and liabilities as if the error has never occurred and present the necessary adjustments to the opening balance of accumulated profits and (2) restate the comparative figures as if the error had never occurred. This must be completed in the first set of financial statements issued after the error was discovered.

The IAS 8 requirements require Doddergate to retrospectively restate the intangible asset balances, accumulated profit balances and comparative figures as if the error had never occurred.

This would require the intangible asset balance of €800,000 to be written off to equity:

Dr	Retained profit (SOFP)	€800,000	
Cr	Intangible assets (SOFP)		€800,000

Further disclosure is required for a PPE: (1) the nature of the prior period error, (2) the amount of the correction to each financial statement line item presented for prior period and (3) the amount of the correction at the beginning of the earliest period presented.

Issue 5: **[8 marks]**

Under IFRS 9's - *amortised cost model*, the financial liabilities should initially be recognised at the fair value of the cash received. Any directly attributable costs to the bond issue should be offset against the carrying amount of the liability.

Therefore, at initial recognition the bonds should be measured at:

	€
Fair value of consideration received	950,000
Less: transaction costs	(18,000)
Carrying amount	932,000

The initial recognition and measurement of the financial liabilities has been carried out correctly in Doddergate's financial statements. However, IFRS 9's amortised cost method requires the bonds to be amortised over the bond term using the effective interest rate.

The instrument cash flows are:

	€
CF0	932,000
CF1	(50,000)
CF2	(50,000)
CF3	(1,050,000)

The effective interest rate which discounts back the future cash flows to the instrument's present value is 7.62% (rounded to 2 decimal places).

The debt amortisation schedule for the debt, using the effective interest rate, is shown below:

Year	**Opening capital balance (SOFP)**	**Coupon interest payment**	**Effective interest expense**	**Difference: to capital sum**	**Closing capital balance (SOFP)**
	€	€	€	€	€
0					932,000
1	932,000	(50,000)	(71,018)	21,018	953,018
2	953,018	(50,000)	(72,620)	22,620	975,638
3	975,638	(50,000)	(74,344)	24,344	(18)(rounding)
				-1,000,000	

Doddergate has failed to amortise the bond using the effective interest rate, instead expensing the coupon payment in the profit or loss. Therefore, the following correcting journal entry is required:

Dr	Interest expense(P&L)	€21,018	
Cr	Non-current liability (SOFP)		€21,018

Issue 6: **[8 marks]**

IAS 23 - *Borrowing Costs* applies. Borrowing costs may be capitalized during the construction of a qualifying asset. A qualifying asset is any asset which takes an extended period of time to get ready for its intended use or sale. Directly attributable borrowing costs may be capitalised if incurred during the capitalisation period.

The capitalisation period commences when borrowing cost has been incurred, interest has been incurred and construction activities have commenced. The last of those three conditions is met on 1st March 2017.

The capitalization period is suspended between 1st June 2017 and 31st July 2017 because there is an extended delay in the construction of the machine due to the labour dispute faced by the engineering company.

The capitalization period ceases on the 1st December 2017 when the machine is substantially ready for its intended use (production).

Therefore, there are two capitalization periods in this example:

1: 1st March 2017 – 1st June 2017 [3 MONTHS]

2: 1st August 2017 – 1st December 2017 [4 MONTHS]

Interest Expense: €500,000 x 6% x 3/12 = €7,500
€500,000 x 6% x 4/12 = €10,000
€7,500 + €10,000 = €17,500

Less: Interest earned on surplus funds:
€300,000 x 1% x 3/12 = €750
€300,000 x 1% x 2/12 = €500
€100,000 x 1% x 2/12 = €167
€750 + €500 + €167 = €1,417

Borrowing costs to be capitalized: €17,500 - €1,417 = €16,083

Journal entry:

DR.	PPE (SOFP)	16,083	
CR.	Interest Expense (P&L)		16,083

Issue 7: **[4 marks]**

IAS 24 - *Related Party Disclosures* applies. Jan Kroes is the Managing Director of Doddergate and the non-executive Chairman of VoltEizzer. Doddergate and VoltEizzer have transacted and an amount is outstanding at the end of the financial year. IAS 24 states that two entities are not related parties just because they have a director or key manager in common. Doddergate and VoltEizzer are therefore not related parties under IAS24. No further disclosures are required under IAS 24. Jan Kroes is, however, a related party to both Doddergate and VoltEizzer, but this is irrelevant to Doddergate's required disclosures under IAS 24.

SOLUTION 3 **[15 marks]**

Answer must attempt to quantify the impact of the recommended accounting adjustments on the loan covenant metrics outlined in the loan agreement.

Loan covenant ratio: long-term interest bearing debt (LTD) to total equity

	Description	Numerator €	Denominator €	Ratio
Loan covenant requirement				≤0.70
Ratio based on current draft figures		2,450,000	3,570,000	0.69
(1)	Acquisition of SubHat	2,870,000	3,730,500	0.77
(2)	Warranty provision		-89,250 +11,156	
		2,870,000	3,652,406	0.79
(3)	Share options	-	-	0.79
(4)	Capitalised research expenditure		(800,000)	
		2,870,000	2,852,406	1.00
		21,018	(21,018)	
(5)	Error bond interest	2,891,018	2,831,388	1.02
			16,083	
(6)	Capitalisation of borrowing costs	2,891,018	2,847,471	1.02
(7)	No effect			

Loan covenant ratio: long-term interest bearing debt (LTD) to total assets

	Description	Numerator €	Denominator €	Ratio
Loan covenant requirement				≤0.40
Ratio based on current draft figures		2,450,000	6,380,000	0.38
(1)	Acquisition of SubHat	2,870,000	6,969,000	0.41
(2)	Warranty provision		11,156	
		2,870,000	6,980,156	0.41
(3)	Share options	-	-	0.41
(4)	Capitalised research expenditure		(800,000)	
		2,870,000	6,180,156	0.46
		21,018		
(5)	Error bond interest	2,891,018	6,180,156	0.47
			16,083	
(6)	Capitalisation of borrowing costs	2,891,018	6,196,239	0.47
(7)	No effect.			

The company has breached the loan covenants based on the recommended accounting adjustments. The acquisition of SubHat Ltd alone would have caused the group's financial position to breach the covenants: the subsidiary has long-term interest bearing debt that is consolidated with the group's debt figure. The only two adjustments which do not have negative implications for the loan covenants is the adjustment for the share options and the capitalisation of borrowing costs, which are insignificant and have no impact on the loan covenant metrics.

The answer should make useful and reasonable recommendations. In particular, the answer should recommend Jan Kroes contacts and negotiates with the bank. Doddergate is profitable and solvent; it is likely the bank will accept the breach and possibly be willing to renegotiate the loan covenants.

SOLUTION 4 **[15 marks]**

Answer comprehensively evaluates the ethical dilemma and recommends either safeguards or actions to resolve the dilemma. Answer may use a model to overcome the dilemma. For example, the ethical model in the IFAC Code of Ethics:

Facts:

- There are a number of accounting issues that will require adjustments to be made.
- The company is at risk of breaching two loan covenants which are based on equity, asset and debt figures in the financial statements.
- Breaching the loan covenants would legally render the loan due immediately and in full. This would threaten the company's solvency.
- The Managing Director has asked you to exercise your professional judgement in a manner that will "avoid recommending any accounting treatment that increases the likelihood of breaching our loan covenants."
- It appears as if there was a dispute with the previous financial accountant that resulted in the accountant leaving the company on bad terms.
- It appears as if Jan Kroes is threatening your position, "The previous accountant was unable to see the bigger picture and refused to play a part in keeping the company in business. I hope you're different."

Principle(s) Threatened: Independence, objectivity, integrity, competence and due care and professional behaviour.

Threat(s): Self-interest and intimidation.

Assessment:

Integrity - Cannot be associated with preparing a report that is misleading, furnished recklessly or involves omissions or obscure information. Selecting accounting policies to avoid breaching loan covenants could result in financial information that is misleading to the bank and other capital providers.

Objectivity – avoid bias, conflict of interest and undue influence of others. The comments by Jan Kroes could be perceived as subtle threats that may compromise objectivity.

Professional competence and due care – must act in accordance with professional and technical standards. For example, must be guided by the Conceptual Framework for Financial Reporting (2010) which outlines the objective of general purpose financial reporting and the characteristics of useful financial information. Accounting policies should be selected and recommended based on the objective and principles outlined in the Conceptual Framework: to provide useful financial information to existing and potential capital providers to aid capital allocation decisions. Information must be relevant and faithfully represented to be useful.

Professional behaviour – avoid actions that discredit the profession. Preparing misleading financial reports for the bank and using judgement to manipulate the financial information could bring the profession into disrepute.

Safeguard(s):
Review the company's ethics policy and determine if the company has an ethical officer. Discuss issue with ethical officer.

Without breaching confidentiality, discuss final accounting recommendations with company accountants to ensure selected policies are most appropriate.

Action(s):
Inform Jan Kroes that you will act in line with professional standards and ethical codes.

Provide objective recommendations in line with professional standards and codes.