CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

ADVANCED CORPORATE REPORTING

PROFESSIONAL 2 EXAMINATION - AUGUST 2015

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. A mark of 50 or more is required to achieve a pass in this 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.

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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

Superhero plc (Superhero) is an Irish listed company that manufactures and distributes top-of-the-range security equipment. Superhero prepares consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) up to 30 June each year. As a newly qualified Certified Public Accountant (CPA), you commenced employment with Superhero three months ago. You have just recently returned from vacation to the news that the finance director (another CPA), Brian Thor, has been signed off on long-term sick leave with immediate effect. You understand that Brian was working on the draft consolidated financial statements for the year ended 30 June 2015. Before you went on holiday, you had heard that there was an incident on 1 February 2015 at the main manufacturing plant. The incident was reported in the local newspaper and has subsequently led to a number of personal injury compensation claims. To date, six claims have been made. If these claims are successful, it is likely that a further two staff who were also injured will make claims. Superhero's lawyers estimate that it is probable that the claims will succeed and that the estimated average cost of each pay-out will be €25,000. One thing you are certain about is that Brian Thor had felt under severe pressure to finalise the consolidated financial statements as John Aquaman, the Managing Director of Superhero, was not someone who tolerated staff missing deadlines. Indeed, before going off sick, Brian was known to have been in his office working on the financial statements until 2am.

It is Tuesday morning and you are in your office catching up on some emails when John Aquaman phones, asking you to call into his office immediately. You grab your coffee and head up to John's office.

"*Come in*" he says. "*Did you have a nice holiday? You have probably heard that Brian is off on long-term sick leave. We have a real problem in that we need the draft financial statements finalised by next Monday. There is a board meeting and the final accounts have to be presented before we can agree a date for the auditors to come in*". John then hands you a folder (Appendix 1) containing extracts from the first draft of the consolidated financial statements for the year ended 30 June 2015.

"*Regarding these outstanding issues (see below), I need an explanation of any accounting adjustments, together with any calculations required. You know much more about the technical requirements for IFRS than Brian, as you qualified recently. I think it is important that we don't give the auditors any information that they can use as an excuse to delay the finalisation of their audit report. As you know, I was most unhappy with the standard of the audit service provided last year. I have read in the financial press that IFRS are making increasing use of fair values. However, the board of directors is anxious to use historic cost wherever possible in order to reduce the volatility within the financial statements. At the last board meeting one of the directors suggested that we make more use of a 'true and fair override' where appropriate. I read somewhere that there is something similar in IFRS, and I suggest we make use of that in the preparation of our own financial statements*". John then hands you another folder (Appendix 2) marked 'confidential'. "*The board is considering constructing a new headquarters building and is currently reviewing potential bidders who will be invited to submit for the work. There is an expectation that the work will cost around €30 million, and I would like you to comment on one of the main prospective bidders, Gobuild plc (Gobuild), a company listed on the Irish Stock Market*". John hands you a folder marked 'outstanding issues' and says "*as you know, the year-end profit figure is of critical importance. In order to retain the confidence of shareholders and lenders we need to report as high a profit as possible*". He indicates that, on the assumption that the forthcoming board meeting goes well, you will receive a generous bonus in your next pay packet.

John gets up and opens the door and concludes "*I think you will do a good job for us, good luck.*" You leave and return to your office. When you return to your office you telephone home to say you will not be back until very late.

Outstanding Issues:

1. On 1 October 2014, Superhero acquired six million of Bright Limited's (Bright) eight million issued €1 ordinary shares. The purchase consideration comprised:

    - An issue of four shares in Superhero for every one share acquired in Bright. On 1 October 2014, Superhero's market share price was €4.50.
    - A payment of €10 million in cash, deferred until 1 October 2017. An appropriate discount rate is 8% per annum.

On 1 October 2014, the carrying value of Bright's net assets amounted to €140 million. This was equivalent to the fair value of net assets acquired, except in respect of Bright's internet domain name. The domain was registered several years ago and is maintained by the payment of a small annual fee which is recognised in administrative expenses. However, in September 2014 Bright was offered €4 million by a company in the United Kingdom for the domain name, an offer which was subsequently refused. The directors of Bright were of the opinion that the domain name has an indefinite useful life. Superhero prefers to measure goodwill using the proportionate method wherever possible. The draft consolidated financial statements (Appendix 1) include 24 million €1 ordinary shares recognised in ordinary share capital, with a corresponding figure of €24 million debit included in intangible assets. Bright's profit for the year (attributable to ordinary shareholders) amounted to €8 million.

2. In order to persuade a large retail bank to purchase a new security system, Superhero offered a deferred payment contract. The security system, with a selling price of €4 million, was delivered to the customer on 1 July 2014. The bank paid 20% of the selling price on that particular date. The balance will become payable on 1 July 2015. The applicable finance charge is 8% per annum. The draft consolidated statement of profit and loss and other comprehensive income includes €4 million in revenue with respect to this transaction.

3. During the year ended 30 June 2015, Superhero commenced the redevelopment of one of its manufacturing plants. This particular plant was not in use as the premises were in a state of disrepair. Discussions with architects commenced on 1 November 2014, and planning permission was granted on 1 December 2014. The first expenditure in relation to the redevelopment was incurred on 1 February 2015 and the redevelopment was completed on 30 June 2015. The redevelopment was funded out of loan finance already in place during the year, as follows:

- €7.2 million of loan finance paying 5% interest per annum
- €1.2 million of loan finance paying 6.5% interest per annum.

The total cost of construction work was €1 million and Brian Thor has capitalised €43,333 of finance costs (being eight months of interest on redevelopment costs of €1 million) in the draft consolidated financial statements.

4. The following information is provided in respect to the defined benefit pension plan operated by Superhero for the year ended 30 June 2015:

	€'000
Fair value of planned assets at 1 July 2014	4,500
Present value of obligation at 1 July 2014	5,550
Current service costs	720
Benefits paid	863
Contributions paid	615
Fair value of plan assets 30 June 2015	6,570
Present value of obligation at 30 June 2015	8,363

The yield on blue chip corporate bonds at 1 July 2014 was 5% and all benefits and contributions were to be paid on 30 June 2015. On 1 July 2014, the pension plan was amended to provide additional benefits, effective from that date. The present value of the additional benefits at 1 July 2014 amounted to €525,000.

5. On 1 July 2014, Superhero entered into a four-year lease agreement for a new, specialised piece of machinery. The machine, which had a cash value of €627,200, was leased under an agreement which requires Superhero to make four annual payments of €153,600 on 30 June each year, and an initial non-refundable deposit of €80,000. The deposit was paid on 1 July 2014, and the first annual payment was duly made on 30 June 2015. Both payments were posted to administrative expenses. The machine has an estimated useful life of four years, and Superhero is responsible for the maintenance of the machine during the lease term. Superhero allocates finance charges on the basis of the sum-of-the-digits method.

6. One of the senior engineers at Superhero has been working on a process to improve manufacturing efficiency and, consequently, reduce manufacturing costs. The senior engineer believes that the cost savings will exceed the project costs within twelve months of their implementation. Regulatory testing and health and safety approval was obtained on 1 September 2014 and the project was finally completed on 10 July 2015. Costs of €3 million, incurred during the year to 30 June 2015, have been recognised as an intangible asset. An offer for the new technology of €1.4 million has been received and rejected by the company. John Aquaman believes that the project will be a major success and has the potential to save the company €2 million in perpetuity. The director of research at Superhero is not convinced about the long-term prospects of the new process and is of the opinion that competitors will have developed similar technology within five years. It is estimated that the present value of future cost savings will be €1.9 million over this period. After that, there is no certainty about its future.

7. On 1 July 2014, Superhero issued 3% loan notes with a nominal value of €750,000. They were issued at a 5% discount and issue costs of €13,000 were incurred. The loan notes will be repayable at a premium of 10% after four years. The effective rate of interest is 7.25%.

8. Brian Thor has made a note in the file indicating that in order to avoid adverse publicity, the lawyers have recommended that Superhero settles the personal injury claims out of court as quickly as possible at their estimated amount for all eight employees injured. The personal injury claim is in advanced stages and Superhero's insurance company has agreed to refund the costs of the claim once the claims have been settled. An additional three employees have made claims for stress, rather than injury, arising from the accident. If these claims were to be successful the lawyers have estimated that the likely pay-out would be around €10,000 per employee. However, the lawyers have stated that they believe it would be very unlikely that these employees will win such a case.

REQUIREMENT:

(a) Prepare a confidential report for John Aquaman that includes:

(i) A critique of the required IFRS accounting treatment for each of the outstanding issues above, preparing relevant calculations and discussing the impact, where appropriate, on the Consolidated Statement of Profit or Loss and Other Comprehensive Income and the Consolidated Statement of Financial Position.

(50 Marks)

(ii) In so far as the information provided allows, a revised Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year end 30 June 2015.

(10 Marks)

(b) Critically analyse any ethical issues arising from the information provided in the case study, identifying and explaining any steps that should be taken to address them.

(16 Marks)

(c) Critically evaluate the financial performance and position of Gobuild from the viewpoint of using this company to construct Superhero's new headquarters. You should calculate a maximum of five additional relevant ratios as well as identifying and justifying matters that require further investigation.

(17 Marks)

(d) Discuss whether an agreed international framework for financial reporting is needed in order to resolve practical accounting issues.

(7 Marks)

[Total: 100 Marks]

APPENDIX 1:

Superhero Group
Draft Consolidated Statement of Profit or Loss and Other Comprehensive Income
for the year end 30 June 2015

	€'000
Revenue	13,240
Cost of sales	(8,825)
Gross profit	4,415
Distribution expenses	(2,570)
Administrative expenses	(800)
Profit from operations	1,045
Finance costs	(100)
Profit before taxation	945
Income tax	(213)
Profit for the year	732
Other comprehensive income	-
Total comprehensive income for the period	732

Superhero Group
Draft Consolidated Statement of Financial Position as at 30 June 2015

	€'000
ASSETS	
Non-current assets	
Intangibles	249,477
Property, plant and equipment	786,000
	1,035,477
Current assets	
Inventories	29,018
Trade receivables	45,703
Cash and cash equivalents	23,820
	98,541
Total assets	1,134,018
EQUITY AND LIABILITIES	
Ordinary share capital	1,000,000
Revaluation surplus	900
Retained earnings	62,866
Equity	1,063,766
Non-current liabilities	
Loans	10,252
Current liabilities	60,000
Total equity and liabilities	1,134,018

APPENDIX 2:

Gobuild
Statement of Profit or Loss and Other Comprehensive Income
for the year ending 30 June 2015

	2015	**2014**
	€'000	**€'000**
Revenue	15,300	16,400
Cost of sales	(12,600)	(12,500)
Gross profit	2,700	3,900
Administrative expenses	(500)	(600)
Profit from operations	2,200	3,300
Finance costs	(100)	(200)
Profit before tax	2,100	3,100
Income tax	(400)	(600)
	1,700	2,500
EPS	*6.8 cents*	*10 cents*

Gobuild
Statement of Financial Position as at 30 June

	2015		**2014**	
	€'000	**€'000**	**€'000**	**€'000**
ASSETS				
Non-current assets				
Property, plant and equipment		22,400		20,100
Goodwill		11,600		12,300
Current assets				
Inventories	6,100		7,200	
Trade receivables	4,800		3,500	
Cash	2,600		1,500	
		13,500		12,200
Total assets		47,500		44,600
EQUITY AND LIABILITIES				
Issued capital 1€ ordinary shares		25,000		25,000
Share premium		3,500		3,500
Retained earnings		3,000		2,200
		31,500		30,700
Non-current liabilities				
Long-term borrowings		8,500		9,000
Current liabilities				
Trade payables	5,600		2,800	
Other payables	1,900		2,100	
		7,500		4,900
Total equity and liabilities		47,500		44,600

Additional information:

	2015	2014	Industry Average 2014
P/E ratio	15.5	13.5	16.8
Return on capital employed	5.5%	8.3%	9%

- The company dividend has been maintained at 5 cents per share, the same level as in 2014.
- The order book is healthy, with a number of firm commitments for work throughout 2016 and 2017.

Other information:

the 8% relevant present value (pV) rates are as follows:

Year	PV
1	0.9259
2	0.8573
3	0.7938
4	0.7350
5	0.6806
6	0.6302

SUGGESTED SOLUTIONS

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SOLUTION 1

(a)
Note: these are suggested solutions, but were students have made valid and relevant points/arguments marks are awarded accordingly.

Report Confidential

To: John Aquaman

From: CPA

Subject: Superhero: Commentary on accounting treatment of outstanding issues for financial statements year ended 30 June 2015

Date: xx/xx/xxxx

Dear John,

As requested, I have set out below the accounting treatment for each of the outstanding issues. In each case, I have prepared relevant calculations and discussed the relevant impact(s) on the financial statements. A revised Consolidated Statement of Profit and Loss and Other Comprehensive income for the year ending 30 June 2015 has been included in the appendix.

Issue 1
Acquisition of Bright
The acquisition of 6 million out of eight million shares currently in issue does appear to confer control upon Superhero, because 75% of the ordinary shares were acquired and there is no indication to the contrary. From 30 June 2014, therefore, Bright should be consolidated as a subsidiary, with 100% of revenue, assets, expenses and liabilities recognised in the consolidated financial statements, along with the non-controlling interest of 25%. Assets and liabilities should be recognised at fair value of acquisition. The domain name in Bright appears to meets the criteria for recognition as an intangible asset under IAS38 Intangible Assets. It is clearly separable (can be sold and purchased separately) and it arises from contractual rights. The recent bid for it suggests that its fair value is €4 million, and this should be added to the existing total of net assets to give a revised figure of €144 million.

An intangible asset with an indefinite life should be tested annually for impairment. No amortisation adjustment is required.

An adjusting accounting entry is required in respect of the initial issue of shares by Superhero. It was correct to recognise €24 million ordinary share capital but an adjustment is also required to share premium, 24 million shares at the then current market price of €4.50 results in a purchase consideration of €108 million. A credit to the share premium (108-24) of €84 million is required. The investment should be reversed and replaced with goodwill on consolidation.

Purchase consideration also comprises deferred consideration which will be payable in cash on 1 October 2017. This should be recognised on acquisition at a discounted value, calculated as follows:

€10 million x 1 /(1.08)3 = €7.9m (rounded). This discount should be unwound until the date of payment on 1 October 2017. Each year the amount unwound should be recognised as a finance cost in profit or loss. For the nine months ended 30 June 2015 the finance cost should be: €7.9m x 8% x 9/12 = €474,000. This amount should be added to the deferred consideration liability: €7.9m + €0.474m = €8.4m (rounded).

Goodwill should be calculated as follows:

	€ '000
24 million new shares at €4.50	108,000
Deferred consideration	7,900
	115,900
Non-controlling interest (NCI) (€144 x 25%)	36,000
	151,900
Less: fair value of net assets at date of acquisition	144,000
Goodwill	7,900

Journals required

		€ '000	€ '000
Dr	Consolidated assets and liabilities (SOFP)	144,000	
Dr	Goodwill (SOFP)	7,900	
Cr	Investment in Bright (Intangibles)		24,000
Cr	Share premium		84,000
Cr	Non-controlling interest (SOFP)		36,000
Cr	Deferred consideration (SOFP)		7,900
Dr	Finance cost (SPLOCI)	474	
Cr	Deferred consideration (SOFP)		474

Profit of the year in the consolidated financial statements should be increased by Bright's profits for the period since acquisition (i.e post acquisition profits): €8m x 9/12 = €6m. Of this, €4.5m is attributable to Superhero, and €1.5m to NCI.

Issue 2

When an extended period of credit is offered to customer (a retail bank in this instance) revenue recognised will have two elements: first, the fair value of the goods on the date of sale, and second, financing income. Future receipts from the bank should be discounted to their present value at the imputed interest rate, in this case 8%.

The customer paid €800,000 on 1 July 2014 (€4m x 20%). At that date the present value of the amount receivable on 1 July 2015 was (€4m x 80%) x 1/(1.08)2 = €2.74m.

Revenue to be recognised in respect of this transaction in the year ended 30 June 2015:

	€'000
Sale of goods (€0.8 + €1.4m)	2,200
Financing income (€2.74m x 8%)	219
	2,419
Carrying amount of receivable (€2.74m x 1.08)	2,959

Superhero has recognised €4m in revenue in respect of this transaction and therefore an adjustment of €1.6m is required.

		€ '000	€ '000
Dr	SPLOCI	1,600	
Cr	Trade receivables		1,600

Issue 3

Under IAS 23 *Borrowing Costs* certain borrowing costs form part of the cost of a qualifying asset. A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. This includes property, plant and equipment provided it is not ready for use. The redevelopment of the manufacturing plant is therefore a qualifying asset, as it was in disrepair and not in use.

Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds. Only borrowing costs that are directly attributable to the acquisition, construction or production of the qualifying asset should be capitalised – which are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. If the construction is financed out of general borrowing then:

- The borrowing costs capitalised should be calculated with reference to the weighted average cost of borrowings
- The weighted average calculation should exclude borrowings to finance a specific purpose or building.

In the case of Superhero, although there are two loans, neither is for a specific purpose, and so the weighted average cost of the lions should be used to determine the borrowing cost rate for capitalisation purposes. The correct calculation of the weighted average borrowing rate is therefore:

(€7.2 x 5%) + ((€1.2 x 6.5%)/8.4 = 5% (approximately)

1 February 2015 is the date at which the capitalisation can start (therefore 5 months)

Amount to be capitalised is therefore:

€1m x 5% x 5/12 = €20,833.

An adjustment to correct finance costs capitalised in error is needed amounting to € 19,500 (43,333-20,833). PPE will need to be reduced by €20,833and SPLOCI will be reduced by €20,833.

Issue 4

Candidates should provide a brief explanation of the key accounting entries. In particular, they should refer to the re-measurement adjustments and their direct effect on OCI.

			Asset €'000	Obligation €'000	P&L €'000	OCI €'000
At 1 July 2014	Opening balances		4,500	5,550		
	Debit	Credit				
Current service cost	SPLOCI	Obligation		720	(720)	
Past service costs	SPLOCI	Obligation		525	(525)	
Benefits paid	Obligation	Asset	(863)	(863)		
Contributions paid	Asset	Bank	615			
Net interest expense:						
Asset	Asset	P&L Finance	225		225	
Obligation	P&L Finance					
Obligation						
			4,477	6,208		
Re-measurement -fair value gain on asset	Asset	OCI	2,093			2,093
Re-measurement actuarial loss on obligation	OCI	Obligation		2,155		(2,155)
At 30 June 2015	Closing balances – A&O		6,570	8,363	(1,296)	(62)

The net obligation in the SOFP at 30 June is €1,793,000.

Issue 5

Under IAS17 *Leases* the machine should be classified as a finance lease as Superhero is leasing the asset for the whole of its useful life and is responsible for the maintenance of the machine during that period. Therefore, as per IAS17, the risks and rewards of ownership should be deemed to have passed to the lessee.

The finance lease should be capitalised at its fair value of €627,200 and the lease set up as:

		€ '000	€ '000
Dr	PPE –cost (SOFP)	627.2	
Cr	Lease liability		627.2

The asset should then be depreciated over its four year useful life giving a depreciation charge of €156,800.

		€ '000	€ '000
Dr	SPLOCI	156.8	
Cr	PPE –asset (SOFP)		156.8

The lease liability should then be reduced by the payments made and increased by interest- spreading the total finance charge of €67,200 (€80,000 + (€153,600 x 4) - €627,200) over the period of the lease on the sum-of-the-digits basis. The sum of the digits is 10 so the charge for 2015 is €26,880 (€67,200 x 4/10). The table below illustrates the entries which should have been made (in SPLOCI and SOFP).

Year-ended	**Bal/bf**	**Interest**	**Payment**	**Bal/cf**
	€	€	€	€
30 June 2015 (€627,200 - €80,000)	547,200	(4/10 x 67,200) 26,880	(153,600)	420,480
30 June 2016	420,480	(3/10 x 67,200) 20,160	(153,600)	287,040

The lease liability at 30 June 2015 is therefore €287,040 non-current and €133,440 (420,480 – 287,040) current.

Issue 6

IAS38 *Intangible Assets* requires an instantiable asset to be recognised if, and only if, certain criteria are met. Regulatory approval on 1 Septembers 2014 was the last criterion to be met, the other criteria have been met as follows:

- Intention to complete the asset is apparent as it is a major project with full support from the board
- Finance is available as resources are focused on project
- Costs can be reliably measured
- Benefits expected to exceed costs (2 years?)
- An amount of €2.5m (€3m x 10/12) should be capitalised in the SOFP representing the expenditure since 1 September. The expenditure prior to 1 September (2/12 x €3m) should be recognised as an expense, retrospective recognition as an asset is not allowed.

IAS 36 *Impairment* requires an intangible asset not yet available for use to be tested for impairment annually. A cash flow of €2m in perpetuity would clearly have a present value in excess of €1m and hence there would be no impairment. However, the research director is technically qualified so impairment tests should be based on her estimate of a five-year remaining life and a present value of the future cost savings of €1.9m. This is greater than the offer received (fair value less costs to sell) of €1.4m and should be used as the recoverable amount. The carrying amount should be reduced to this amount and an impairment loss of €0.6m recognised in the profit and loss for the year.

		€ '000	**€ '000**
Dr	Operating expenses- development expenditure	500	
Dr	Operating expenses – impairment of intangible	600	
Cr	Intangible assets-development expenditure		1,100

Issue 7

The event took place after the year end of the reporting period. If an event that occurs before the financial statements are authorised for issue provides evidence of conditions which existed at the end of the reporting period then it is classified as an adjusting event, and in such a case the financial statements must be adjusted to reflect it. The flood does not fall into this category, and so is regarded as non-adjusting event in accordance with IAS10 Events after the Reporting Period. However, the standard also provides that where non-adjusting events are material, and where they could influence the economic decisions made by users, the events should be disclosed. Disclosure should comprise a description of the event and wither an estimate of its financial effect or a statement that such an estimate cannot be made.

In this case, it is not clear whether the loss of €1.2m is material. However, the loss of 25% manufacturing capacity is likely to be a material issue and therefore a disclosure should be made.

Issue 8

IFRS9 *Financial Instruments* financial assets can be measured at fair value through profit and loss or at amortised cost. Amortised cost is the cost of an asset or liability adjusted to give a constant effective interest rate over the life of the asset or liability. Financial assets not carried at FVTPL are subject to an impairment test. A financial asset measured at amortised cost applies only to debt instruments and must be designated upon initial recognition. In this instant, the financial assets initially measured at fair value plus transaction costs. IFRS9 requires debt instruments to meet two tests (business model test and cash flow test) in order for it to be measured at amortised cost.

Amount that loan notes should be measured at on 1 July 2014:

Proceeds €750,000 x 95%	=	€712,500
Issue costs	=	€(13,000)
		€699,500

Year	**Balance on 1 July**	**Interest @ 7.25%**	**Paid**	**Balance on 30 June**
	€'000	**€'000**	**€'000**	€'000
2015	699.5	50.71	(22.5)	727.71
2016	727.71	52.76	(22.5)	757.97
2017	757.97	54.95	(22.5)	790.42
2018	790.42	57.31	(847.5)	0.23*

*
Rounding
SPLOCI – for year-ended 30 June 2015 – finance costs €50.71('000)
SOFP – 30 June 2015 €727.71

Issue 9
There should be a provision made for the personal injury claims amounting to 8 x €25,000 = €200,000.

Leal claim (note)
During the year an accident at one of the company's manufacturing plants caused a number of employees to suffer injury. This provision is to cover personal injury claims made by individuals concerned. This provision is based on lawyers' best estimate of the likely amount at which the claims can reasonably be settled. It is hoped that the claims will be settled in the next financial year. It is expected that the full amount of these claims will be reimbursed by the insurance company following their payment.

Contingent liability
Following the accident a number of employees have made claims for undue stress. Based on lawyers' advice the company does not believe these claims will be successful. If such as case was to be successful, the estimated pay-out would be €20,000.

(50 Marks)

(ii) See Appendix (10 Marks)

(b) *Potential issues that could be discussed*
From the case there is an argument for suggesting that John Aquaman appears to be applying pressure to have accounting treatment of certain items in such a way that auditors will not query them. Brian Thor has gone on sick leave due to stress that there appears to be a culture of autocratic management by John Aquaman. International Financial Reporting Standards are very clear on the issues outlined in the case. In particular, he seems to be suggesting that non-compliance with IFRS can be equated with the 'true and fair view' override (per companies act). In any event, IFRS are designed to operate in all legal environments so they cannot provide for departures from the legal requirements in any particular country. IAS1 Presentation of Financial Statements does allow non-compliance with IFRS, but only in extremely rare circumstances where management concludes that compliance with IFRS would be so misleading as to conflict with the objectives of general purpose financial reporting as set out in the IASB Conceptual Framework.

Students may also have referred to the fact that the offer of a generous bonus is not acceptable 'ethical' practice. The pressure being applied to ensure that the year-end profit figure is as high as possible is not acceptable. In terms of using historic costs, there is still options within certain accounting standards (IAS16/IAS40) to use either historic cost or revaluation model, but the emphasis of the IASB (as evidenced by the recent standard on fair value- IFRS13) is on valuing assets and liabilities at their fair value. Fair values are seen as being more relevant to users and will provide more relevant and consistent reporting. The failure to report transactions involving financial instruments appropriately has potentially contributed to a number of recent accounting scandals. The complexity of many financial instruments presents challenges for financial reporting .Significant judgements are required in determining fair values and classifying instruments as equity or debt.

(16 Marks)

(c)

	2015	**2014**
Gross profit margin	17.65%	23.8%
Interest cover	22 times	16.5 times
Trade receivables days	114 days	78 days
Trade payables days	162 days	82 days
Current ratio	1.8 times	2.5 times
Return on shareholders' funds	5.4%	8%

Revenue has fallen by 6.7% (15.3-16.4/16.4 x 100), and the gross profit percentage has reduced by a significant amount. The reduction in gross profit may be attributable to smaller amount of work available due to the economic downturn. This may have led to competitive pressures and reductions of margins. Gobuild's operating margin has also reduced by 4%. Savings have been made on administrative expenses as evidenced by the 17% drop in these expenses. This is a positive factor but as a potential customer we would need assurance that the quality of service has not suffered. Finance costs are a low level, and interest cover gives us no cause for concern.

The reduction in margins follows through to the bottom line. Profit after tax has suffered a significant reduction (32%), and as a consequence, the earnings per share (EPS) is also lower. While the position of the investors is not the primary concern for us (we are potential customers), it is obviously helpful to the health and prospects of the business if they continue to support it. The dividend has been maintained but it is not at a high level relative to EPS. We would need more information regarding the share price, The P/E ratio is relatively low, but it is more or less in line with the sector average, and so there is no immediate concern.

The statement of financial position does not indicate significant investment in non-current assets. Goodwill presumably relates to acquisitions, although these must have been wholly owned as there is no non-controlling interest in equity. Goodwill has fallen indicating there may have been an impairment charge – more information is required on this. PPE as expected in a business which rents rather than buys equipment is at a relatively low level. It can be assumed that as a construction business, Gobuild accounts for most of its activities under IAS11 Construction Contracts. This may explain the relatively low amounts of inventory. Both receivables and payables are relatively high and, although application of IAS11 may have a role to play here, need to be investigated. As indicated by the receivables and payables days, these have almost doubled in the last year. The company has cash in hand but these figures are low relative to the high payables figures. Current ratio has deteriorated in the last year, although, this may be characteristic of the industry. Gobuild's long-term borrowings are relatively low, with a consequent low level of finance costs. Borrowings have reduced slightly during the year. Retained earnings are low and the company may have been recovering from a period of heavy loss making. More information is needed on this point.

A good indicator of future prospects in this industry is the state of the order book. As per the case study, the order book is very healthy for 2016 and 2017. We should review newspaper and other media reports about Gobuild to ensure that there has been no adverse reporting in relation to the company being unable to fulfil contract terms etc.

Because a construction contract will extend over several accounting periods, it is important for a customer to have some indication of the financial stability of the contractor. The relatively low level of borrowings is reassuring in this respect. On the other hand, the deterioration in the current ratio could be a cause for concern in the future. Also, the low level of profitability, while possibly typical for this type of industry, could be a problem, in that only a small reduction in profitability could cause significant losses.

Matters requiring further investigation

- Further information on industry averages
- Cash flow information
- Further information regarding the order book – value of contracts etc
- Share price has fallen – why?

(17 Marks)

(d) The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. Although, theoretical in nature, a conceptual framework for financial reporting has practical aims.

The danger of not having a conceptual framework is demonstrated in the way some countries' standards tend to be produced in a haphazard way. Where an agreed framework is in place, the IASB can act as the architect – building accounting rules on the foundation of sound, agreed basic principles. The lack of a conceptual framework means that fundamental principles are tackled more than once in different standards, thus producing inconsistencies (e.g. prudence and matching). This leads to ambiguity and it affects the true and fair concept of financial reporting. There is also the problem that standards become ever sophisticated rules rather than principles governing financial reporting. A well thought out conceptual framework can also help standard setters in resisting political interference (lobbying etc).

Resolving practical issues
- Can't solve all the problems
- Provides a set of coherent principles which can be used when devising alternatives
- Framework can also provide guidance in the absence of accounting standard

However, unlikely to provide all the answers:
- Financial statements are intended for a variety of users and it is not possible for a single framework to satisfy all users. For example, social and environmental accounting issues.
- Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a different purpose
- There is an argument that the conceptual framework makes to task for preparing financial statements more difficult.
- In creating the framework – who is deciding what accounting represents (i.e. is it the accountants who are creating reality?).
- Focus is on suppliers of capital and decision-making. What about the stewardship function of accounting?
- Private sector focus - what about the not-for-profit sector?

Candidates should demonstrate their depth and breadth of reading in this area. (7 Marks)

Appendix
Revised Draft Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year end 30 June 2015

Adjustments

	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000
	Draft	(1)	(2)	(3)	(4)	(5)	(6)	(8)	(9)	Final
Revenue	13,240	6,000	(1,600)							11,640
Cost of sales	(8,825)					(156.8)				(8,982)
Gross profit	4,415									2,658
Distribution expenses	(2,570)									(2,570)
Administrative expenses	(800)				(720)		(1,100)	(200)		(3,345)
Profit from operations	1,045				(525)					(3,257)
Finance costs	(100)	(474)		(20.833)	(276)	(26.88)		(50.71)		(723)
					225					
Profit before taxation	945									(3,980)
Income tax	(213)									(213)
Profit for the year	732									(4,193)
Profit of Bright										6,000
Total profit for year										1,807
Total comprehensive income for the period	732									1,807
Profit attributable to Group										307
NCI										1,500