CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

ADVANCED CORPORATE REPORTING

PROFESSIONAL 2 EXAMINATION - AUGUST 2017

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.

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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

Serox Plc (Serox), currently operating in the biotechnology research and healthcare sector, is an Irish listed company which prepares financial statements in accordance with International Financial Reporting Standards (IFRS) up to 31 December each year. Founded in 2012, the company manufactures drugs, using proprietary formulation technologies to make them more effective, safer and easier to take. To date, the company's product portfolio has focused on pain relief and rheumatic disease indications, addressing unmet patient needs with substantial commercial potential in global markets. Since incorporation, the company has invested significantly in research and development, focusing on existing medicines proven to be safe and effective. As the company has built up cash reserves, the directors have made the decision to concentrate on growth through the acquisition of other biotechnology companies in Ireland. You are a qualified CPA accountant at Serox and report directly to Paul Conlon, the financial controller. On 1 January 2015, Serox acquired 80% of the equity interests of Palax Limited (Palax). On 1 July 2016, Serox acquired 60% of the equity interests of Buspar Limited (Buspar). Paul Conlon has sent you the following email:

From: Paul Conlon
To: CPA Accountant@Serox.com
Date: 25 January 2017

Good afternoon,

As you are aware, I have to present some financial information at the board meeting scheduled for the end of the month and I need your help. Your predecessor prepared specific briefing notes (see below) regarding the preparation of the consolidated financial statements of the Serox Group for the year ended 31 December 2016.

I am not sure whether I mentioned at our last meeting that we are looking to make another acquisition. Augment Limited (Augment), is a private company and has recently had an application for additional funds rejected from its current bankers on the basis that there are insufficient assets to offer security. I have asked Joan Barton, our financial analyst, to provide more information on this company, and her email is attached below. My own view is that this would be a good investment, but I would really value your opinion on Augment's financial performance and position, together with a recommendation as to whether we should consider an investment in this company.

I recently attended a CPA continuing professional development course in Dublin. One of the main topic areas was how to improve the quality of information that we report at the year end. The key speaker made the argument, which I fully support, that the annual report and relevant disclosure notes (prepared in accordance with IFRSs) do not satisfy the information needs of the users. She suggested that we should look at producing a more integrated annual report which brings together both financial and non-financial information. I think we should give this some serious consideration, particularly in light of the pressure we are under to demonstrate how we contribute to sustainable development in relation to our impact on society and the environment.

I am really not convinced that traditional financial reporting, and its preoccupation with economic profit, is sufficient to address the diverse requirements of our users. Moreover, and I think you will agree, the Conceptual Framework for Financial Reporting does not really address this issue.

We have recently entered into a contract with Moher Ltd. (Moher), a wholesale chain, to supply a generic drug to the value of €2 million. The terms of the contract are such that payment is due one month after the sale of the goods. On the basis of experience with other contracts with similar characteristics, Serox considers that there is a 5% risk that the customer will not pay the amount due after the goods have been delivered and the rights transferred. I believe the financial condition of the customer has recently deteriorated and that the trade receivables have been further impaired by €200,000. The board will want to know how the above transaction would be treated in the financial statements under IAS 18 *Revenue* and also whether there would be any difference in treatment if the collectability of the debt is taken into account. An annual discount rate of 5% should be assumed in any calculations.

Serox also made a loan of €25 million to a homeless charity for the building of a community centre. The loan was made on 1 January 2016 and is repayable on maturity in four years' time. Interest, which is subsidised, is to be charged one year in arrears at 4%, but Serox assesses that a normal rate for such a loan would have been 8%. Serox recorded a financial asset at €25 million and reduced this by the interest received each year. Finally, your yearly appraisal meeting is coming up next month, so it would be to your advantage if you do a good job on this assignment.

Kind regards.
Paul

From: Joan Barton
To: Pconlon@serox.com
Date: 23 January 2017

Dear Paul,

As discussed, I have attached the most recent financial statements of Augment for the year ended 31 December 2016. For the last eight years, the company has been manufacturing and selling its own brand non-steroidal anti-inflammatory drugs. Over the last fifteen months, the company has invested in developing an online presence. The sales director has also used his extensive contacts to secure a deal with a chain of wholesale pharmacies for Augment to manufacture a new anti-inflammatory drug. The contract was set up on 1 July 2016, and has generated revenues of €8.5 million and a strong gross profit margin. Eamon Zebo (the managing director of Augment) now wishes to build on the work of the sales director to develop further sales opportunities. However, the financial institution that currently provides the long-term loan and overdraft facility (secured on Augment's property, plant and equipment) has rejected Augment's application for additional funding.

If you need any further information, just let me know.

Best wishes,
Joan

You have been reviewing the minutes of Serox's last board meeting, dated 28 December 2016. The minutes indicate that the sales director resigned on 1 December 2016. In her resignation letter to the board, the sales director states that she can no longer work with Paul Conlon who is dominating the board and allowing a close friendship with, and advice from, Eamon Zebo to compromise his judgement. The Human Resources department is currently in the process of recruiting a new sales director. Paul Conlon tells the board that, in the interim, the marketing department will just have to cope until a replacement sales director is appointed.

Speaking to other staff in Serox, you have become aware that the wife of the managing director of Serox is a partner in Brother and Co., a firm of solicitors which the company uses to provide legal advice in relation to the market development activities of Palax. However, Brother and Co. has confirmed that she works in a different division to that which provides services to Palax and that she has no involvement in the services provided. It is your understanding that legal fees of €500,000 (included in administration expenses) were paid by Serox to Brother and Co. during the year ended 31 December 2016.

You begin to ponder how you will to be able to get the information to Paul Conlon in just five days. You are anxious about your performance appraisal at the end of the month, so you put your phone on to voicemail, turn off your emails and get down to work. You start by reading the briefing notes that Paul sent as part of his email on 25 January 2017.

Briefing notes:

1. The purchase consideration for the acquisition of Palax consisted of €120 million and the fair value of identifiable net assets acquired, at that date, was €165 million cash. The fair value of non-controlling interest in Palax was estimated at €70 million on 1 January 2015. Paul Conlon has indicated that he wants to use the 'full goodwill' method for accounting for all acquisitions. At the date of acquisition, equity share capital and retained earnings of Palax were €30 million and €98 million, respectively. Other reserves at that date amounted to €10 million. Any excess of the fair value of the identifiable net assets at acquisition is due to an increase in the value of non-depreciable land.

   The purchase consideration for the acquisition of Buspar was cash of €105 million. Buspar's identifiable net assets at the date of acquisition were €130 million and the non-controlling interest had a fair value of €41 million at that date.

2. In relation to the Palax acquisition, goodwill has been impairment tested at 31 December 2015 and was found to have reduced by 25%. However, on conducting an impairment test on 31 December 2016, it was found the impairment had reversed and goodwill was now valued at €4 million above its original value at the date of acquisition of Palax. The upward change in valuation of goodwill has already been reflected in the separate draft financial statements of Serox (Appendix 1) prior to the preparation of the group accounts.

3. Serox operates a defined benefit pension plan. On 1 January 2016, the fair value of plan assets amounted to €58 million and the actuarial valuation of the defined benefit obligation at that date was €62 million. Contributions during the year received by the fund were €4 million and the benefits paid to employees during the year amounted to €5.5 million. The yield on blue chip corporate bonds at 1 January 2016 was 6%. Actuarial calculations indicate that current service costs for the year to 31 December 2016 is €2 million. The contributions paid is the only item that has already been accounted for within the financial statements. At 31 December 2016, the fair value of plan assets amounted to €60 million and the actuarial valuation of the defined benefit obligation was €68 million.

4. In April 2016, a customer of Serox brought legal proceedings against the company for alleged injury due to a faulty product. In December 2016, the issue came to court, but lawyers acting for Serox are of the opinion that the case will be very lengthy and that Serox will lose. The actual cost of damages and timing of the case are unclear, but management have made a number of estimates. They believe that the best outcome for Serox will be damages of €300,000 payable in one year's time. The least favourable outcome would be for the case to continue for three more years whereby the estimate of damages and costs is €1.5 million payable in three years' time. A middle ground estimate is that damages of €900,000 would be payable in two years' time. Estimates of probabilities are: best outcome 25%, worst outcome 20% and middle ground outcome 55%. No provision or any disclosure has been included in the financial statements in relation to this legal case.

5. Due to a change in Serox's production plans, an item of machinery with a carrying value of €11 million at 31 December 2016 (after adjusting for depreciation for the year) may be impaired due to a change in use. An impairment test conducted on 31 December 2016, revealed its fair value less cost of disposal to be €5 million. The machine is now expected to generate an annual net income of €2 million for the next three years at which point the asset would be disposed of for €2.4 million. An appropriate discount rate is 10%. Serox charges depreciation at 20% on reducing balance method on machinery.

6. During the year 31 December 2016, Serox sold goods to Buspar (at fair value) for €16 million. Serox made a loss of €3 million on this transaction. At the year end, half of the inventory sold to Buspar remained unsold.

7. Included in 'other current assets', Serox has a portfolio of receivables which are currently valued at €50 million. On 31 December 2016, Paul Conlon signed a factoring agreement with a financial institution whereby Serox will receive €47 million in cash in exchange for the receivables. Serox has agreed to reimburse the financial institution for any shortfall between the amount collected and the amount of cash advanced. Once the receivables have been collected, any amounts in excess of €47 million, net of interest, will be repaid to Serox. Serox has derecognised the receivables and charged €3 million to the profit and loss account.

8. As an incentive to persuade a potential customer to buy a large quantity of a new drug, (Straton), Serox offered a deferred payment arrangement. The drug, with a selling price of €2 million, was delivered to the customer on 1 January 2016. The customer paid 25% of the selling price on that date. The balance will become payable in 1 January 2018. The applicable finance charge is 10% per annum. A sum of €2 million was recognised as revenue in the draft financial statements in respect of this transaction.

REQUIREMENT:

1. Prepare a report for Paul Conlon that includes the following:

(a) A justification of the required IFRS accounting treatment for the Moher contract, the issue of the loan to the charity, the defined benefit pension plan, the legal claim and the impairment of machinery. You should present relevant calculations and discuss the impact of any adjustment arising, where appropriate, on the consolidated statement of profit or loss and other comprehensive income and the consolidated statement of financial position for the Serox Group for the year ended 31 December 2016.

(30 Marks)

(b) The consolidated statement of profit and loss and other comprehensive income of the Serox Group as at 31 December 2016, in accordance with the relevant IFRSs.

(20 Marks)

(c) A critical analysis of the financial performance and position of Augment Ltd. Your answer should outline any matters that require further investigation.

(21 Marks)

2. Discuss the ethical issues arising from the information provided in the case study, and the appropriate steps to address them.

(13 Marks)

3. With reference to the points raised by Paul Conlon regarding the quality of accounting information reported, critically discuss the limitations of financial reporting and the extent to which integrated reporting might improve the usefulness of the annual report.

(16 Marks)

[Total: 100 Marks]

APPENDIX 1:

Serox Plc
Draft
Statements of Profit or Loss and other Comprehensive Income for the year ended 31 December 2016

	Serox	Palax	Buspar
	€m	€m	€m
Revenue	600	174	110
Cost of sales	(480)	(100)	(55)
Gross profit	120	74	55
Other income	25	12	4
Distribution costs	(15)	(11)	(8)
Administrative expenses	(23)	(14)	(16)
Other expenses	(34)	(18)	(7)
Operating profit	73	43	28
Finance costs	(7)	(8)	(5)
Finance income	10	7	12
Profit before tax	76	42	35
Income tax	(28)	(14)	(7)
Profit for the year	48	28	28
Other comprehensive income – revaluation surplus	15	-	-
Total comprehensive income for the year	63	28	28

Appendix 2:

Augment Limited
Statement of Profit and Loss and Other Comprehensive Income for the year ending 31 December

	2016	2015
	€m	€m
Revenue	32	18.5
Cost of sales	(20.5)	(13)
Gross profit	11.5	5.5
Other income	0.5	0.2
Distribution costs	(2.3)	(2)
Administration costs	(4.6)	(2.5)
Finance costs	(0.4)	(0.2)
Profit before tax	4.7	1
Income tax	(0.5)	(0.1)
Profit for the year	4.2	0.9

Augment Limited
Statement of Financial Position as at 31 December 2016

	2016 €m	2015 €m
Assets		
Non-current assets		
Property, plant and equipment	2	1.8
Intangible assets – development costs	0.2	0.1
	2.2	1.9
Current assets		
Inventories	6.5	6
Trade receivables	2.3	1.6
Cash and cash equivalents	-	0.2
	8.8	7.8
Total Assets	**11**	**9.7**
Equity		
Issued capital 1€ ordinary shares	2.8	2.8
Retained earnings	3.7	3
Total equity	6.5	5.8
Non-current liabilities		
Long-term borrowings	2.2	2
Current liabilities		
Trade and other payables	1.8	1.9
Overdraft	0.5	-
	2.3	1.9
Total Equity and Liabilities	**11**	**9.7**

Other Information:

Discount Rates

Year	8%	10%
1	0.926	0.909
2	0.857	0.826
3	0.794	0.751
4	0.735	0.683
5	0.681	0.621

END OF PAPER

SUGGESTED SOLUTIONS

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These Are Suggested Outline Solutions Only. Candidates who present alternative and relevant approaches to the case study questions, will be awarded marks accordingly.

A broad range of answers would be acceptable here – it is important that candidates present their argument, make reference to recent pronouncements on integrated/sustainability reporting and refer to specific issues raised in the case study.

SOLUTION 1

(a) Report format.

(i) Moher Contract (IAS18)

Under IAS 18, revenue of €2 million would be recognised for the contract and a receivable of €2 million would be set up. The trade receivable would be reviewed periodically for impairment, and the deteriorating financial situation of the customer would be seen as an indicator of impairment. An impairment of €200,000 would be recognised. However, no recognition would be made, under current rules of the 5% risk that the customer would default. This is not 5% of the revenue – of it were, a receivables expense of €100,000 would be required – but a 5% risk that none of the revenue would be collected, for which IAS 18 makes no arrangements.

If credit risk were taken into account in the recognition of revenue, the amount recognised on the sale would be reduced by 5% likelihood of default. Meaning only 95% of the revenue, i.e. €1,900,000 would be recognised. The impairment of €200,000 would still be recognised as an expense, not a reduction in revenue. Currently, IAS 18 does not take account of credit risk.

(4 marks)

(ii) Charity bond (IFRS9)

The fair value of the bond is determined by calculating the present value of all future cash receipts using the prevailing market interest rate for a similar financial instrument. This will result in a lower figure than the amount advance. The difference is recognised in profit or loss.

	Cash flows €m	**Discount factor**	**PV €m**
2016	1	0.93	0.93
2017	1	0.86	0.86
2018	1	0.79	0.79
2019	26	0.74	19.24
			21.82

The fair value of the loan is calculated by scheduling the cash flows due to take place over the life of the loan and discounting them to present value at the unsubsidised rate of interest. The making of the loan should have been accounted for as:

	€m	**€m**
Dr Financial assets	21.8	
Cr Cash		25
Dr Profit or loss	3.2	

The asset is then held at amortised cost.

1 January 2016 €m	**Interest rate (8%)**	**Cash received**	**31 December 2016 €m**
21.8	1.7	(1)	22.5

Correcting entries:

	€m	€m
Dr SPLOCI	3.2	
Cr Financial asset		3.2
Dr Financial asset	1.7	
Cr SPLOCI		1.7

Candidates should discuss effect on SFP and SPLOCI.

(10 marks)

(iii) *Note 3: Pension Obligation (IAS19)*

To calculate the remeasurement component, you need to reconcile the opening and closing net pension deficit. The remeasurement component is accounted for in OCI.

The liability recognised in the financial statements for the year ended 31 December 2016 is €6m (€68m -€62m).

	€m
Net obligation at 1 January 2016 (€62m -€58m)	4
Net interest component (€4m x 6%)	0.24
Contributions	(4)
Service cost component	2
Remeasurement loss (bal figure)	5.76
Net obligation at 31 December 2016	8

	Dr (€m)	Cr (€m)
SPLOCI	2.24	
Net obligation (NCL)		2.24
Cash		4
Net obligation (NCL)	4	
Remeasurement (other reserves)	5.76	
Net obligation (NCL)		5.76

IAS19 does not specify where net interest costs have to be shown, therefore, it would be acceptable to show the €0.24m under finance costs.

(6 marks)

(iv) *Note 4: Legal case*

Candidates would be expected to refer to IAS37 Contingent Liabilities and Contingent Assets. If conditions met then provision must be made. The assessment of provision for legal claim is always a difficult area as it will be based upon relevant evidence available. In this case, lawyers and management are fairly certain that damages and costs will be payable. As there is a timescale involved, it will be necessary to calculate the present value of various outcomes.

Outcome	€m	DF @ 10%	PV	Probability	EV
Best	0.3	1/1.10	0.27	0.25	0.068
Most likely	0.9	1/1.102	0.74	0.55	0.41
Worst	1.5	1/1.103	1.3	0.20	0.26
					0.74

IAS37 requires the estimated value of the provision to be the amount that the entity would rationally pay to settle the obligation.

	€m	€m
Dr SPLOCI (Serox)	0.74	
Cr Provisions (SFP)		0.74

(5 marks)

(v) *Note 5*

Under IAS36 Impairment, The machinery needs to be tested for impairment.

	€m
Carrying value	11
Recoverable amount (€2 x 2.4868) + (€2.4 x 0.7513)	(6.8)
Impairment	4.2

Recoverable amount is the higher of value in use (€6.8m) and fair value less costs of disposal (€5m)

	€m	€m
Cr (PPE)		4.2
Dr SPLOCI - Serox	4.2	

(5 marks)

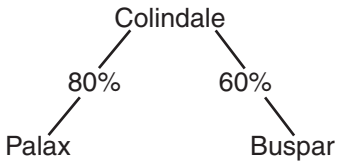
[Total: 30 Marks]

(b)

Serox Group
Consolidated Statement of Profit or Loss and other Comprehensive Income for the year ended 31December 2016

	€m
Revenue [600 + 174 + (110 x 6/12) + 2(Wa) - 0.14(W5) +3(W4) -16(W6)]	817.86
Cost of sales [480 + 100 + (55 x 6/12) – 16(W6)]	(591.5)
Gross profit	226.36
Other income [25 + 12 + (4 x 6/12)]	39
Distribution costs [15 + 11 + (8 x 6/12)]	(30)
Administrative costs [24 + 14 + (16 x 6/12) + 0.2 (Wa) + 0.74(Wd)]	(46.94)
Other expenses [34 + 18 + (7 x 6/12) + 2.24 (Wc) + 4.2(We) +10.25(W2)]	(72.19)
Operating profit	117.23
Finance costs [7 + 8 + (5 x 6/12) +1.5(Wb)]	(1.9)
Finance income [10 + 7 + (12 x 6/12)]	23
Profit before tax	138.33
Income tax [28 + 14 + (7 x 6/12)]	(45.5)
Profit for the year	92.83
Other Comprehensive Income	
Items which will not be reclassified to profit or loss:	
Changes in revaluation surplus	15
Remeasurement – defined benefit plan (Wc)	(5.76)
OCI	9.24
Total comprehensive income for the year	102.07
Profit attributable to:	
Owners of the parent (bal figure)	90.87
NCI (W7)	11.2
	102.07

W1 Workings – group structure



(2 marks)

W2 Palax's goodwill

	At Acquisition date €m
Fair value of consideration	120
Fair value of non-controlling interest	70
	190
Less Fair value of identifiable net assets acquired	(165)
Goodwill at acquisition	25
Impairment 25%	(6.25)
	18.75

The goodwill has increased to €29m (€25m + €4m). However, past impairments of goodwill can never be reversed. Therefore €9m needs to be charged to profit or loss to undo reversal and to reduce goodwill to its correct amount of €18.75m.

	€m	€m
Dr SPLOCI	10.25	
PPE		10.25

(3 marks)

W3 Buspar's goodwill

	At Acquisition date €m
Fair value of consideration	105
Fair value of non-controlling interest	41
	146
Less FV of identifiable net assets acquired and	(130)
Goodwill	16

(3 marks)

W4 Note 7: Derecognition

Under IFRS9 *Financial Instruments* a financial asset must be derecognised if:

(i) The contractual rights to cash flows have expired
(ii) The financial asset has been transferred, together with risks and rewards.

Serox still bears the risks and rewards of ownership. Accordingly, the receivable must be reinstated.

	€m	€m
Dr Receivables (SFP)	50	
Cr SPLOCI		3
Cr loan (CL)		47

(2 marks)

W5 Note 8: Deferred payment – Straton

This is issue surrounding revenue recognition (IAS 18 *Revenue*). Where an extended period of credit is offered to a customer, revenue recognised as two elements: first the fair value of the goods on date of sale, and second, financing income. Future receipts from the customer should be discounted to present value at an imputed interest rate, in this case 10%.

The customer paid €0.5m on 1 January 2016 (€2m x 25%). At that date the present value of the amount receivable on 1 January 2018 was (€2m x 75%) x 1 /(1.10)2 = €1.24m. Revenue to be recognised in this transaction in the financial statements to the year ended 31 December 2016:

	€m
Sale of goods (€0.5m + €1.24m)	1.74
Financing income (1.24 x 0.10%)	0.12
	1.86
Carrying amount of receivable (€1.24 x 1.10)	1.36

Serox has recognised €2 million in revenue regarding this transaction and therefore adjustment of €0.14m (approx.) is required.

	€	€
Dr SPLOCI (Revenue)	0.14	
Cr Trade Receivables (SFP)		0.14

(4 marks)

W6 Note 6: Intra-group sale

Intra-group trading must be eliminated from consolidated revenue and cost of sales. Any unrealised profits should also be eliminated by increasing cost of sales. However, if a loss is made on intra-group trading, it may suggest that the value of goods has fallen and therefore that the loss has been actually realised.

The loss on inventory is not eliminated from group profit or loss. Because the sale is at fair value, the inventory must have been impaired and therefore the loss on sale must remain realised. However, the revenue and cost of sales amounting to €16m must be eliminated.

	€m	€m
Dr SPLOCI (Revenue)	16	
Cr Cost of Sales		16

(2 marks)

W7 NCI

	€m
Palax:	
Profit for year	28
NCI (share of post-acq profits) 20% x 28	5.6
Buspar:	
Profit for year	28
NCI (share of post-acq profits) 40% x (6/12 x 28)	5.6
NCI	11.2

(2 marks)

Presentation Marks (Report CSPLOCI etc) (2 marks)

[Total: 20 Marks]

(c) The aim of this brief report is to analyse the performance and position of Augment and determine whether it would be a good investment.

Performance

Growth

Revenue has increased by an impressive 73% in the year. This is mainly due to the appointment of a new sales director who has set up an online presence and secured a lucrative deal with a chain of wholesale pharmacies – generating 26% of the revenues in 2016. In addition, with the sales director's extensive contacts, other such deals could be generated in the future.

Profitability

Gross margin has improved from 19% (2015) to 36% in 2016. It would be helpful to have an analysis of the margins of the three different segments of the business. Net profit margin has also improved from 6% to 14.4% despite the increase in finance costs – caused by the increase in overdraft and long-term borrowings. Overheads associated with running an online business would be lower than those associated with normal business outlets (which use expensive business premises).

Augment could improve their overheads cost control though as administrative overheads have increased by 84% in the year to 31 December 2016. This may be due to the initial costs of setting up the new contract. However, a more detailed breakdown of costs would be required in order to establish whether this were, in fact, the case. Distribution costs have increased by 15%; which is proportionately below the increase in revenue (perhaps as a consequence of the online business).

Return on capital employed (using PBIT / Capital Employed) has increased from 15% to 58%, primarily due to the increase in profit margin and the increase in asset turnover.

Financial Position

Liquidity

The current ratio has declined slightly from 4.1 to 3.8 – largely due to the reliance on bank overdraft in the current year and the reduction in receivable days. However, the quick ratio has slightly increased from 0.96 to 1.0 largely due to paying suppliers more quickly (32 days compared to 53 days).

Working capital management

Inventory days have decreased from 168 days to 115 days indicating that Augment is selling their inventories more quickly. This could be to meet the increased demand for online sales and the new contract with wholesale pharmacies. Inventory days remain high though – this may be due to the nature of the product (shelf-life of the drugs). There is a risk in terms of potential obsolescence.

Receivable days are low (2016; 26 days; 2015 32 days) as would be expected with sales that are predominantly on a cash basis. Paying suppliers early is perhaps inadvisable given that the company is now relying on increased overdraft funding. It may be that they are dealing with suppliers who are imposing strict terms of trade.

Capital structure
Despite the fact that Augment are finding it difficult to secure funding from a financial institution, the gearing remains at a reasonable level (34% in the current year). Furthermore, interest cover is a healthy 11.75 times for the year to 31 December 2016.

Conclusion
Notwithstanding the ethical issues outlined in (b) below, there is a strong case for investing in Augment. The business is innovative and is growing, In addition, the company is also profitable and the profitability is improving year on year. One concern is the reliance on the overdraft, but this could be resolved by improving working capital management. One area that would need investigation is whether the owner-managers are paying themselves excessive dividends. However, profitable the company this, together with the ethical issue (see below) needs clarification before a firm decision is made as to whether an investment should be made.

Ratio calculations: 8 marks
Discussion: 10 marks

(21 Marks)

SOLUTION 2
Ethical issues

- It is of some concern that Paul Conlon is linking the accountant's annual appraisal and the preparation of the financial statements.

- The resignation (as per Board Minutes 1 December 2016) of the sales director does give some cause for concern. In particular, the extent to which Paul Conlon is able to dominate the board, poses questions around the governance of Serox. The company is operating without the key skills of a sales director. The board is therefore not acting effectively and there would appear to be a lack of transparency around Paul's behaviour.

- Students may also have referred to the fact that the managing director wife is a partner in Brother and Co. This could result in a serious conflict of interest. In this case, the managing director and his wife can be considered to be related parties from the viewpoint of Serox and Palax Ltd. Therefore, Brother and Co. could be viewed a related party of both companies. The wifes's lack of involvement in the services does not exempt her from being considered a potential related party. The nature of the transaction is such that it is appropriate to disclose details of in the financial statements of both Serox and Palax. Moreover, the services provided and the monetary amounts involved should be disclosed.

- As a CPA, you should consider the Code of Ethics in formulating a way to resolve any conflicts that appears to be developing. It is essential that CPAs do not succumb to pressure from management.

- Issues around the financial appraisal of Augment – given the company's existing bankers refuse to provide further funding. This is important given Paul Conlon's close relationship with the managing director of Augment – a potential future acquisition target for Serox.

(13 Marks)

SOLUTION 3
Candidates should demonstrate an awareness of current issues in relation to social integrated/ sustainability reporting.

Issues that Paul Conlon needs to be made aware of.
Potential problems in relation to current financial reporting under IFRS include:

- Focus on single economic bottom line (i.e. profit)
- Ignores social and environmental externalities
- Financial accounting has myopic focus on information needs of suppliers of capital and those making resource allocation decisions.
- Materiality used to make decisions as to whether to include items in financial statements
- Discounting of future liabilities for inclusion in financial statements or impairment testing does not make sense in the context of providing for environmental and social impacts.
- Entity assumption – of transaction does not impact the entity it is ignored for accounting purposes
- Estimates – e.g. allowance for doubtful debts
- Problem of measurability – reasonable accuracy is not possible for many social and environmental impacts and so they are not recognised.
- Financial accounting requires professional judgement – includes subjectivity which can reduce comparability
- Many companies are now providing voluntary information. Problem is there is no consistency/comparability. Disclosures based on legitimacy.

Recently debate has moved toward corporate sustainability in this context is a complex and contested concept it is about ensuring that there are sufficient resources available for future generations. It is very difficult for this to be addressed at individual level of the firm. Recent developments include reporting on what is known as the Triple Bottom Line (i.e. economic, social and environmental. Many of the top 250 companies are now producing separate Sustainability Reports in addition to their annual financial statements.

Integrated reporting is defined as a 'concise communication about how an organisation's strategy, governance, performance and prospects, in the context of the external environment, lead to the creation of value in the short, medium and long term'. Value is conceptualised in terms of a range of capitals – not just financial capital. Integrated reporting is more forward looking than the traditional annual financial report, so they can help users in decision-making. Integrated reporting takes a wider (holistic) view of an entity than traditional financial reporting. Issues of 'risk' and 'governance' are given priority in these reports. Financial and non-financial information is included in these reports – so financial and management accounting are connected. Importance of discharging accountability to range of stakeholders.

However, judgement is still critical in preparing these reports. They are voluntary, so comparability will be difficult. The issue of whether these reports should be assured by a third party needs to be considered. There is some connection between integrated reporting and complying with the GRI (Global Reporting Initative guidelines). There is also a linkage that could be made between integrated reporting and sustainability reporting.

Who is driving the agenda – corporate organisations: business as usual/power relationships.

Balanced argument/practical examples and conclusion **(16 Marks)**