International Financial Reporting and Analysis, 7th edition

David Alexander, Anne Britton, Ann Jorissen, Martin Hoogendoorn, Carien van Mourik

Solutions Manual for Students

Any solutions not provided here can be obtained from your instructor.
Chapter 1 A brief introduction to international financial reporting

1 Obviously the scope here is almost endless. Here are three definitions from the USA (extracted from Belkaoui (2004: 38) Accounting Theory, 5th edn, Cengage Learning EMEA).

‘The Committee on Terminology of the American Institute of Certified Public Accounting defined accounting as follows:

Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.¹

The scope of accounting from this definition appears limited. A broader perspective was offered, by the following definition of accounting as:

The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.²

Accounting has also been defined with reference to the concept of quantitative information:

Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature about economic entities that is intended to be useful in making economic decisions, in making resolved choices among alternative courses of action.³

2 Financial statements represent an account of the financial position of the business at different points in time, and the financial performance over a period of time. This information and the process of preparing it are part of the corporate governance of a firm and its accountability to other financial statement users. Information about the entity’s financial performance is per definition about the past. At the time the financial statements are issued, the information on the entity’s financial position is about three months old. Users must use this financial statement information about the recent past and combine this with other information about the past and present (both qualitative and quantitative, and both from within the firm and outside the firm) for their current purposes.

Such purposes are often to do with the steps to take now in order to generate a desired outcome in the future. When considering the types of decisions that the different user groups need to make, accountability and stewardship type of decisions are better served by information that is more objectively and reliably determined because monitoring agents relies on objectively verifiable information. On the other hand, many people think that the decision-usefulness function is better served by information that is as timely and future oriented as possible. In case of the efficient contracting perspective, incentivising and monitoring agents may require information with different characteristics depending on the principal’s tolerance or appetite for risk. For example, well-diversified investors may not have as much of a preference for objectively determined reliable information as lenders do. Consider:

■ relevance v. reliability
■ objectivity v. usefulness

¹ ‘Review and resume’, Accounting Terminology Bulletin No.1, American Institute of Certified Public Accountants, New York, 1953, paragraph 5.
producer convenience v. user needs.

3 Perhaps it all depends on what ‘reasonably’ means. The needs of different users are certainly different (illustration required), but greater relevance from multiple reports would need to be set against:
(a) costs of preparation
(b) danger of confusion and the difficulties of user education.
Chapter 2 International Accounting Differences

1 The answer to this question will be influenced to a large extent by the national background of the student. In the Anglo-Saxon world students will more easily argue that accounting is, in essence, economics based. In those countries, accounting standards are rather broad and derived from general principles. These principles are often derived from economic valuation concepts. Students living under a codified law system and in countries with a creditor orientation will argue more often that accounting is law based. We might argue that IFRS is economics based (e.g. economic substance over legal form).

2 The answer to this question is strongly influenced by the items put forward in the section ‘national differences will they still play a role in the future?’ in Chapter 2. As large companies become more global and seek multi-listings, they will be strongly in favour of harmonization and even uniformity. For small local firms the national environment will remain an important factor shaping their financial reporting practices.
1 An argument in support of the statement is that the European Union has adopted IFRS and in that way handed over setting accounting standards to the IASB. However, one argument against the statement is that accounting regulation, and accounting practice, in Europe are bound by the contents of the 2013 European Accounting Directive (2013/34/EU), and the 4th and 7th Accounting Directives, which the 2013 Directive combines, updates and consolidates. The second argument is that because of the endorsement mechanism for emerging IFRSs the European Commission still has the final decision on endorsing, amending or not endorsing an individual IFRS. Furthermore, the European Financial Reporting Advisory Group (EFRAG) not only gives endorsement advice the European Commission, it also works hard to influence the development of IFRSs.
1 There are those who regard financial accounting as essentially a practical activity. Certainly, like any service industry, financial reports have to have a practical usefulness. It is also fair to say that financial reporting cannot be theorized about in the sense that pure science can be. However, in our view, theorizing about financial reporting is essential, for two main reasons. First, it will help to produce more consistent and therefore, hopefully, more useful treatments of accounting difficulties. Second, it will make clear to us all what uncertainties and subjectivities still remain. Knowledge of one’s weaknesses is always useful!

2 To paraphrase the question, the proposition is that we need to know what tends actually to happen, so that we can discuss what should happen instead in an informed, sensible and knowledgeable way, but automatic acceptance of what does actually happen is not acceptable. Discussion needed; we would agree with the proposition.
Chapter 5 Accounting and economic perspectives on income and capital

2 The two businesses will have different depreciation charges (if they depreciate the buildings at all) and significantly different capital employed totals. They will therefore certainly have different efficiency and return ratios, but are they, economically speaking, different situations? In one sense, yes: more money was put into one than the other; but in another sense, no: opportunity costs and future potential are logically identical. Discuss generally.

3 A tricky one. In one sense, a capital maintenance concept must be defined before income can be determined, suggesting separation is not possible. But since one, in a sense, leads to the other, it could be suggested that perhaps we can define one of them and then automatically deduce the other (which therefore does not need separate definition). Discussion of interrelationships is the key issue.
**Chapter 6 Current values, mixed values measurement and CPPP accounting**

1 In essence, CPP adjustments attempt to update financial measurements for changes in the value of the measuring unit, without altering or affecting the underlying basis of valuation - usually, but not necessarily, historical cost. They do it by using general averaged index adjustments - usually, but again not necessarily, by means of a retail price index. Perhaps give or invite illustration.
2 It is often argued that realized results must be distinguished from the results of valuation changes or capital-related movements and that the best way to do this is to produce two separate statements. The trouble with this in practice is that the existence of two statements may enable managers to put more favourable elements in the more high-profile statement (i.e. the income statement) and less favourable items in the other statement.
Chapter 9 Corporate governance

2 Chapter 2 considered different taxonomies of financial accounting and reporting systems starting from the existing legal system, provision of finance, the link between accounting and taxation. This chapter (p. 189-190) talked about the distinction between market-based economies and bank-based economies, insider systems and outsider systems, civil law and common law systems and the varieties of capitalism literature.

Countries with older industrialised market-based economies have more developed capital markets, and are more likely to have (had) private financial accounting standard setters and therefore the accounting profession is more likely to be self-regulated. Corporate governance mechanisms and practices in these countries are those classified by Franks and Meyer as outsider corporate governance systems.

5 In the US companies are legally obliged to comply with the Sarbanes Oxley Act. On the other hand, in the UK the Financial Reporting Council sets the Corporate Governance Code (for companies) and the Stewardship Code (for investors). The Corporate Governance Code sets out a number of key components of effective board practice. It is based on the underlying principles of all good governance: accountability, transparency, probity and focus on the sustainable success of an entity over the longer term. A UK company must either comply, or explain in which ways and why it does not comply with the Corporate Governance Code.

7 Looking at Activity 9.4, perhaps the corporate governance mechanisms that work best in an outsider system are predominantly those mechanisms that address the agency problems through incentivising managers in the relatively short term (managerial remuneration, managerial ownership and the corporate takeover market). On the other hand, those that work best in insider systems rely more on monitoring over the longer term.
Chapter 10 Business ethics, CSR, sustainability reporting and SRI

1 Reasons why companies should take CSR reporting seriously could include:

- **The normative ethics case:** Taking seriously the company’s social responsibilities because it is the right thing to do requires reporting on what responsibilities the company addresses, how it does that, and how this impacts on its other stakeholders and the environment.

- **The sustainable business case:** Some believe that it is in the interest of the company’s long-term survival to carry out its business in a sustainable manner. This requires reporting on the company’s sustainable business management, and how this impacts on all of its stakeholders and the environment.

- **The business case:** Some believe that corporate social responsibility is a matter of business strategy, in other words, it is profitable. This is more likely to be the case when the business model and products/services aim to serve this particular segment of the market. The need then arises to be accountable for achieving the sustainability aims and the manner in which this is achieved.

- **The PR case:** Others see CSR reporting as a matter of compliance and public relations rather than as an integral part of the business strategy or mission.

2 The instrumental approach to stakeholder theory in corporate governance has led to the idea of stakeholder management. Stakeholder management requires the identification of the stakeholders and their interests in order to communicate with them and manage their expectations and influence their behaviour. Underlying the IR Framework is the thinking that investors need to know how an organization creates value over time. The assumption is that value is not created by or within an organization alone. It is influenced by the external environment, created through relationships with stakeholders, and it is dependent on various resources. Hence, in essence it is about reporting and being accountable to investors, not so much about accountability to any other stakeholders.
Chapter 11 The ethics of the accounting profession

2 Being straightforward and honest in performing professional services sounds easier than it sometimes is. Honesty and straightforwardness is not always a matter of knowing what is straightforward and what is not, or what is honest and what is dishonest.

In a discussion paper in 2009, the Federation of European Accountants (FEE) argued that integrity the core principle for professional accountants. (https://www.icaew.com/-/media/corporate/files/technical/ethics/integrity-in-professional-ethics-fee-discussion-paper.ashx)

An important point of advice given in this paper is regular training on how to maintain independence as a means of preserving integrity. This paper could be useful resource for informing any discussion on this topic.

5 The next day, Amy may not even remember what she has done. When she finds out she realises that she has behaved unprofessionally by getting drunk and violating her client’s confidentiality, and in doing so has lost her professional integrity. She could talk to a senior colleague to ask for advice. She could talk to her friends to tell them that they must not act upon the information. Perhaps, she could do nothing because she thinks that the scale is so small that it does not really matter in the grand scheme of things. No solution is particularly pretty.
Chapter 12 Fixed (Non-current) Tangible Assets

7. This is more difficult. There are two arguments in favour of requiring the revaluation of buildings. First, it makes statement of financial position numbers more relevant and, second, through the resulting increase in depreciation charged based on up-to-date cost levels, it makes the reported profit a better estimate of long-run future performance (assuming an upward revaluation). Note that the resulting reported operating profit, being usually lower, is more prudent when upward revaluation takes place. But, again, there are reliability considerations.

8. If the buildings are current assets, which is quite possible, then depreciation is definitely not logical. For investment properties, we are into the general ‘fair value’ debate, about which strong, and different, views are likely to be found. If regular fair values are to be recognized, then depreciation is not appropriate. However, if it is considered that the physical characteristics of an asset are more important than its intended use by management, the preceding arguments will be rejected.

10. Errsea – Statement of Profit or Loss for the year ended 31 March 2007 (extracts)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on disposal of plant</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation for year</td>
<td>75,000</td>
</tr>
<tr>
<td>Government grants</td>
<td>19,000</td>
</tr>
</tbody>
</table>

Errsea – Statement of Financial Position as at 31 March 2007 (extracts)

<table>
<thead>
<tr>
<th></th>
<th>Cost $</th>
<th>Accumulated Depreciation $</th>
<th>Carrying Amount $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>360,000</td>
<td>(195,000)</td>
<td>165,000</td>
</tr>
</tbody>
</table>

Current assets

- Grant receivable: 48,000

Non-current liabilities

- Government grants: 27,000

Current liabilities

- Government grants: 39,000

Working (i)
The cost of the acquired plant is recorded at $210,000 being its base cost plus the costs of modification and transport and installation. Annual depreciation over three years will be $70,000. Time apportioned for year ended 31 March 2007 by 9/12 = $52,500.

Working (ii)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost as at 1 April 2006</td>
<td>240,000</td>
</tr>
<tr>
<td>Less asset disposed on 1 April 2006</td>
<td>(90,000)</td>
</tr>
<tr>
<td>Depreciation rate 15%</td>
<td>22,500</td>
</tr>
</tbody>
</table>
Working (iii)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government grant (25% of Base)</td>
<td>$48,000</td>
</tr>
<tr>
<td>Income in the year ended 31 March 2007 (48,000/3 x 9/12)</td>
<td>$12,000</td>
</tr>
<tr>
<td>Classified as current liability (48,000/3)</td>
<td>$16,000</td>
</tr>
<tr>
<td>Classified as a non-current liability (balance)</td>
<td>$20,000</td>
</tr>
<tr>
<td>Total</td>
<td>$48,000</td>
</tr>
</tbody>
</table>

Note: government grants are accounted for from the date when the qualifying conditions for the grant have been met.

Working (iv)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liability</td>
<td>$</td>
</tr>
<tr>
<td>Balance brought forward</td>
<td>$10,000</td>
</tr>
<tr>
<td>Grant repaid (per question)</td>
<td>$(3,000)</td>
</tr>
<tr>
<td>Income in the year ended 31 March 2007</td>
<td>$(7,000)</td>
</tr>
<tr>
<td>Transferred from non-current liabilities (per question)</td>
<td>$11,000</td>
</tr>
<tr>
<td>On acquired plant (Working (iii))</td>
<td>$16,000</td>
</tr>
<tr>
<td>Total</td>
<td>$27,000</td>
</tr>
</tbody>
</table>

Non-current liability

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance brought forward</td>
<td>$30,000</td>
</tr>
<tr>
<td>Transferred to current liabilities (per question)</td>
<td>$(11,000)</td>
</tr>
<tr>
<td>On acquired plant (Working (iii))</td>
<td>$20,000</td>
</tr>
<tr>
<td>Total</td>
<td>$39,000</td>
</tr>
</tbody>
</table>

Working (v)

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
<th>Accumulated Depreciation</th>
<th>Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances brought forward</td>
<td>$240,000</td>
<td>$(180,000)</td>
<td>$60,000</td>
</tr>
<tr>
<td>Disposals</td>
<td>$(90,000)</td>
<td>$(60,000)</td>
<td>$(30,000)</td>
</tr>
<tr>
<td>Additions (working (i))</td>
<td>$210,000</td>
<td>$(52,500)</td>
<td>$157,500</td>
</tr>
<tr>
<td>Other assets plant depreciation (working (ii))</td>
<td>$(22,500)</td>
<td>$(22,500)</td>
<td>$(22,500)</td>
</tr>
<tr>
<td>Balance as at 31 March 2007</td>
<td>$360,000</td>
<td>$(195,000)</td>
<td>$165,000</td>
</tr>
</tbody>
</table>

11. (a) The issue of depreciation of properties is dealt with in IAS 16 *Property, plant and equipment* and IAS 40 *Investment property*. IAS 16 states that all property, plant and equipment with finite useful economic lives should be depreciated over those estimated lives. IAS 16 further states that land generally has an infinite useful economic life but that buildings have finite useful economic lives. IAS 16 requires that properties be split into components for depreciation purposes, the buildings component being depreciated but the land component not being depreciated. A depreciation calculation is therefore obligatory, but it is perfectly possible, especially perhaps with property, for the “depreciable amount” (i.e. cost less estimated residual value) to be negative. In such case the correct annual depreciation charge would be nil. This seems likely to be the case here, but the words used in the scenario are not explicit, as they seem to focus on the relatively short term.

Property 3 is being held for investment purposes and so is governed by the provisions of IAS 40. IAS 40 gives entities a choice regarding the accounting treatment of investment properties. One possibility is to use the cost model. If this model is used then the properties are dealt with in accordance with IAS 16. In this case, then as already explained, a depreciation calculation would be required. The other
possibility is to use the fair value model. Under this model investment properties are measured at their fair values, with changes in fair value being reflected in profit or loss for the period. Therefore if the entity chooses the fair value model it would be unable to depreciate property 3.

(b) All three properties can either be valued using the cost model or using the fair value model. Under IAS 16 (applicable for properties 1 and 2) a model is applied to property, plant and equipment on a class by class basis. Properties would be regarded as a separate class of property, plant and equipment. As stated in part (a), under IAS 40 (applicable for property 3) either the cost model or the fair value model would be applied to all investment properties.

Property 1

Where the cost model is used, upward changes in market value would be ignored. Where the fair value model is used, surpluses should be credited directly to equity. Therefore for the both years a surplus of $1 million would be credited to equity in respect of property 1.

Property 2

Where the cost model is used, the increase in the year to 30 September 2005 would be ignored and the carrying amount retained at $10 million. The fact that the market value had declined to $9 million by 30 September 2006 may well indicate that the property has suffered impairment and an impairment review would certainly be necessary.

If the fair value model is used, the surplus of $1 million in respect of property 2 in the year to 30 September 2005 is taken to equity as already explained for property 1. Where a revaluation results in a deficit then the appropriate treatment depends on whether or not there is an existing surplus in the revaluation reserve relating to the same asset. To the extent that there is, then the deficit is deducted from the revaluation reserve as a movement in equity. Any other deficit is charged to the statement of profit or loss as it arises. Therefore the treatment of the deficit of $2 million arising in the year to 30 September 2006 is to deduct $1 million from equity (the revaluation reserve) and $1 million from income.

Property 3

As already explained in part (a) the appropriate treatment of the surpluses ($1·5 million in the year to 30 September 2005 and $1 million in the year to 30 September 2006) depends on whether the cost model or the fair value model is used for investment properties. Where the cost model is used then the surpluses would be ignored but where the fair value model is used they would be taken to the statement of profit or loss.

12.

Transaction 1

<table>
<thead>
<tr>
<th>Cost of production plant</th>
<th>$'000</th>
<th>Reason (refer to IAS 16)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic cost</td>
<td>10,000</td>
<td>Purchase costs included</td>
</tr>
<tr>
<td>Sales taxes</td>
<td>0</td>
<td>Recoverable taxes not included</td>
</tr>
<tr>
<td>Employment costs</td>
<td>800</td>
<td>Employment costs in period of getting the plant ready for use</td>
</tr>
<tr>
<td>Overheads</td>
<td>600</td>
<td>Abnormal costs excluded</td>
</tr>
<tr>
<td>Dismantling costs</td>
<td>1,360</td>
<td>Recognised at present value where an obligation exists</td>
</tr>
<tr>
<td></td>
<td><strong>13,260</strong></td>
<td></td>
</tr>
</tbody>
</table>

Depreciation charge (statement of profit or loss – operating cost)

Per IAS 16 the asset is split into two depreciable components:

$3,000,000 with a useful economic life of four years
$10,260,000 (the balance) with a useful economic life of eight years
The charge for the year ended 31 March 2007 is:
3,000,000 x 1/4 x 10/12 + 10,260,000 x 1/8 x 10/12 = 1,694,000

**Carrying value of asset (statement of financial position – non-current assets)**
$13,260,000 – $1,694,000 = $11,566,000

**Unwinding of discount (statement of profit or loss – finance cost)**
$1,360,000 x 5% x 10/12 = $57,000

**Provision for dismantling (statement of financial position – non-current liabilities)**
$1,360,000 + $57,000 = $1,417,000

**Transaction 2**

Under the provisions of IFRS 5 – *Non-current Assets Held for Sale and Discontinued Operations* – the property would be classified as held for sale at 31 December 2006. This is because the intention to sell the property is clear and active steps are being taken to locate a buyer, with the property being marketed at a reasonable price. In addition there is a clear expectation that the sale will be completed within 12 months.

Where non-current assets are held for sale they need to be initially measured using up-to-date values under the current measurement basis that is being applied. In this case this is the revaluation model. The carrying value based on the latest valuation is $14·76 million ($15 million – ($8 million x 1/25 x 9/12)). This needs to be updated to market value at the date of classification as held for sale – $16 million. Therefore $1·24 million ($16 million – $14·76 million) is credited to the revaluation reserve.

When the asset is classified as held for sale it is removed from non-current assets and presented in a separate caption on the statement of financial position. The (non-mandatory) guidance in IFRS 5 shows this immediately below the current assets section of the statement of financial position.

The asset is measured at the lower of its existing carrying value ($16 million) and its fair value less costs to sell ($16 million – $500,000 = $15·5 million). In this case the asset is written down by $500,000 and this is recognised as an impairment loss in the statement of profit or loss. No further depreciation is charged.

At the year end the carrying value of the asset is the lower of the previously computed amount ($15·5 million) and the latest estimate of fair value less costs to sell ($15·55 million – the actual net proceeds). In this case no further impairment is necessary.

The sale is recognised (and the revaluation reserve realised) on 30 April 2007 and will therefore impact on next year’s financial statements.
Chapter 13 Intangible Assets

1. Intuitively, it seems to us that goodwill is an asset. The only difficulty with this, given the IASB’s definitions, is whether or not an enterprise can control goodwill. It certainly can be expected to give benefit.
3. The overall impairment loss is $2 million ($27 million - $25 million). This loss is first allocated to the asset that has suffered obvious impairment (i.e., the plant), leaving the balance of $1 million to be allocated to goodwill.
Chapter 15 Leases

1. Refer to “Classification of leases into finance lease and operating lease” in the text.

5. (i) (a) Refer to “IFRS 16: Lease Accounting by the Lessee” in the text.
   (i) (b) Refer to “IAS 17: Lease Accounting and Reporting by Lessees” in the text.
   (i) (c) Refer to “Accounting and Reporting by Lessors: Finance Leases” and “Accounting and Reporting by Lessors: Operating Leases” in the text.

(ii)
Statement of profit or loss for the year ended 31 March 20X3 (extract) $ 
Depreciation of leased asset (working (i)) 48,750
Lease interest expense (working (ii)) 12,480

Statement of financial position as at 31 March 20X3 (extract) 
Leased asset at cost 260,000
Accumulated depreciation (working (i)) (113,750)
Net book value 146,250

Current liabilities
Accrued lease interest (working (ii)) 12,480
Obligations under finance leases (working (ii)) 47,520

Non-current liabilities
Obligations under finance leases (working (ii)) 108,480

Working (i)
Depreciation for the year ended 31 March 20X2 would be $65,000 ($260,000 x 25%)
Depreciation for the year ended 31 March 20X3 would be $48,750 (($260,000 - $65,000) x 25%)

Working (ii)
The lease obligations are calculated as follows:
Cash price/fair value at 1 April 20X1 260,000
Rental 1 April 20X1 (60,000)
Interest to 31 March 20X2 at 8% 16,000
Rental 1 April 20X2 (60,000)
Capital outstanding 1 April 20X2 156,000
Interest to 31 March 20X3 at 8% 12,480

Interest expense accrued at 31 March 20X3 is $12,480. The total capital amount outstanding at 31 March 20X3 is $156,000 (the same as at 1 April 20X2 as no further payments have been made). This must be split between current and non-current liabilities. Next year’s payment will be $60,000 of which $12,480 is interest. Therefore capital to be repaid in the next year will be $47,520 (60,000 - 12,480). This leaves capital of $108,480 (156,000 - 47,250) as a non-current liability.
1. Financial Instruments can have a significant impact on an enterprise’s financial performance, position and cash flow. If financial instruments are carried the statement of financial position then the movement in the instrument in favour of or against the enterprise can significantly change its risk profile.
Chapter 18 Revenue

1. Refer to “What is Revenue” in the text. Revenue is regarded by many as simply the cash that you are paid for selling things and this simple idea also implies exchange - cash for things. We have carried this idea of exchange through to the statement of financial position. Consider the simple exchange of selling an item of inventory for cash: the accounting entries would be to derecognize the item of inventory in the statement of financial position and recognize the asset of cash. The asset of cash would qualify as revenue and against this we would match relevant expenses to determine profit. Traditionally, we have not regarded the item of inventory as revenue until it is sold or at least until we have exchanged it for another asset, perhaps a debtor. This approach seems to equate revenue with economic activity involving exchange with a customer and ignores other items such as gains on assets that are revalued or carried at current value.

There are several important elements in the definition of revenue:

1. Revenue is the *gross inflow*, i.e. before the deduction of any expenses.
2. Revenue results from ordinary activities. This distinguishes revenue from other gains. Gains are defined in the Framework as ‘other items that meet the definition of income and may, or may not, arise in the ordinary activities of an entity’.
3. Revenue gives rise to an increase in equity.
Chapter 19 Provisions, Contingent Liabilities and Contingent Assets

6. Refer to “Problems Identified” in the text. In order to provide relevant information to users, it is generally accepted that the provision should be accounted for in the financial statements, whereas the contingent liability should only be disclosed by way of note. This is so that the accounts do not take an overly prudent view of the state of affairs at the reporting date.

9. Many people would argue that IAS 37 lacks prudence in that it does not require the recognition of and accounting for all future expenses. We would not argue this, as we view prudence as a state of being free from bias, not being overly pessimistic.
Chapter 20 Income Taxes

1. Refer to “The Deferred Tax Problem” in the text. Major arguments in favour:
   - profit after accounting for tax provides a better guide to the performance of the company
   - matching
   - prudence
   - quantifiability

4. Refer to “The Deferred Tax Problem” and “Accountants’ response” in the text.

5. Refer to “Deferral versus liability method” in the text.
   - liability method is consistent with aim of partial provision
   - deferral method creates a tax charge relating solely to that period and is not distorted by any adjustments relating to prior periods.

7. Refer to “Income statement or balance sheet (statement of financial position) view of deferred tax” in the text. Matters to address include:
   - definition of deferred tax - what is it?
   - approach to providing for deferred tax - flow through, full deferral, partial deferral?
   - provision for deferred tax - deferral vs liability?
Chapter 21 Employee Benefits

1. The arrangement provides the counterparty with a choice of settlement. In this situation a compound financial instrument has been granted, i.e. a financial instrument with debt and equity components. IFRS 2 requires the entity to estimate the fair value of the compound instrument at grant date, by first measuring the fair value of the debt component, and then measuring the fair value of the equity component, taking into account that the employee must forfeit the right to receive cash in order to receive the equity instruments.

The fair value of the cash alternative is 2,500 X €30 = €75,000. The fair value of the equity alternative is 3,000 X €28 = €84,000. The fair value of the equity component of the compound instrument is a €9,000 (€84,000 - €75,000). Each year an expense will be recognized. The expense will consist of the change in the liability due the remeasurement of the liability. The fair value of the equity component is allocated over the vesting period.

The following amounts will be recognized:

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Expense</th>
<th>Equity</th>
<th>Liability</th>
</tr>
</thead>
</table>
| 1    | Liability component (2,500 X €33)/3 = 27,500  
     | Equity component (9,000/3) = 3,000   | 30,500  | 3,000   | 27,500   |
| 2    | Liability component (2,500 X €36)/2 = 32,500  
     | Equity component (9,000/3) = 3,000   | 35,500  | 6,000   | 60,000   |
| 3    | Liability component (2,500 X €40) = 40,000  
     | Equity component (9,000/3) = 3,000   | 43,000  | 9,000   | 100,000  |

Suppose that at the end of year 3 the directors choose the cash alternative. In that situation €100,000 will be paid to the directors and the value of the liability will be nil afterwards. The equity component remains unchanged. If the directors choose the share alternative. The liability amount will be transferred to the equity account.

2.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
</table>
| 1    | 10 X (100 – 15) X €20 X 1/3  
     | 5,666  | 5,666 | 5,666  |
| 2    | 10 X (100 – 12) X €20 X 2/3 – €5,666  
     | 6,067  | 6,067 | 11,733 |
| 3    | 10 X (100 – 4 – 4 – 6) X €20 – €11,733  
     | 5,467  | 5,467 | 17,200 |

3. Since IFRS requires the entity to recognize the services received from a counter-party who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified period), irrespective of whether that market condition is satisfied, it makes no difference whether the share price target is achieved. The possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the share options at grant date.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
</table>
| 1    | (1,000 X 20) X 80% X €48 X 1/3  
     | 256,000 | 256,000 | 256,000 |
| 2    | (1,000 X 20) X 80% X €48 X 2/3 – €256,000  
     | 256,000 | 256,000 | 512,000 |
| 3    | (1,000 X 17) X €48) – €512,000  
     | 304,000 | 304,000 | 816,000 |
Chapter 22 Changing Prices and Hyperinflationary Economies

1 IAS 29 is adjusting for general inflation, i.e. for the fall in the value of money. It applies a general inflation adjustment to the original, i.e. normally, historical cost figures. It is in no sense, therefore, concerned with valuation of financial statement items.
Chapter 23 Statements of Cash Flows

3. Statement of cash flow must be looked at together with statement of financial position and statement of profit or loss and other comprehensive income. It cannot be used in isolation. The cash flow provides additional information as follows:
   - Cash flow generated from operations
   - Cash flow effect of taxation charge
   - Amounts expended on capital and financial investment
   - Cash generated from operating activities
   - How capital expenditure and investments have been financed (i.e., from operations, issued share capital and long-term debt)
   - Non-controlling interest payments and cash from associates can be clearly seen
   - Whether acquisition of subsidiary has had a positive effect on cash flow.
Chapter 24 Disclosure Issues

1. (a) Basic EPS
   Profit before interest and tax €1,100,000
   Loan interest (1,250,000 @ 8%) (100,000)
   Less tax @35%
   Profit after tax 650,000
   Preference dividends (500,000 @ 7%) (35,000)
   Profit 615,000
   Number of share in issue (1,000,000 @ 25p each) 4,000,000
   EPS 15.38c

   (b) Diluted EPS
   Profit before interest and tax 1,100,000
   Less tax @35%
   Profit after tax 715,000
   Preference dividends (500,000 @ 7%) (35,000)
   Profit 680,000
   Number of share in issue (1,000,000 @ 25p each) 4,000,000
   Convertible loan stock ((1,250,000/100) X 120) 1,500,000
   Diluted EPS 12.36c

2. The reporting to the chief decision maker is based on regions. So the operating segments to be reported in the notes to the statement of financial position and statement of profit or loss can be on the basis or regions. According to IFRS 8, revenues, costs, results and assets must be disclosed in the notes. Operating liabilities might be disclosed.

Quantitative thresholds for the decision on the number of reportable individual operating segments:
   (a) segment revenue (internal and external) above 10% of the total revenue – ok for all segments
   (b) Europe is the only segment with a loss so it represents 100% of the loss making operating segments
   (c) the assets of Europe just fall below the threshold of 10% with regard to the total segment assets

The management discloses all three operating segments as individual reportable segments.

3. (a) Non-adjusting event
   (b) Non-adjusting event
   (c) Non-adjusting event
   (d) Adjusting event
   (e) Non-adjusting event unless the application of the going concern concept to the company is not appropriate.
   (f) Non-adjusting event unless it impacts going concern the application of the going concern concept to the company is not appropriate.
Chapter 29 Basics of Interpretation of Financial Statements

1 (a) There are more than five ratios that will monitor operational performance. We provide six for you.

\[
\begin{array}{c|c|c|c}
\text{ROCE} & \text{Alpha plc} & \text{Omega plc} \\
\hline
\text{20X1} & \frac{957}{4914} = 19.5\% & \frac{240}{7900} = 3.0\% \\
\text{20X2} & \frac{1209}{5652} = 21.4\% & \frac{360}{8120} = 4.4\% \\
\text{20X3} & \frac{1409}{7628} = 18.5\% & \frac{640}{9240} = 6.9\% \\
\end{array}
\]

Return is calculated by adding operating profit and investment income.

Capital employed is calculated by adding overdraft and short-term loans to total assets less current liabilities, as the interest payable in the income data is not separated into long- and short-term interest payable.

\[
\begin{array}{c|c|c}
\text{Profit to sales} & \text{20X1} & \text{20X2} & \text{20X3} \\
\hline
\text{Alpha plc} & \frac{1157}{16929} = 6.8\% & \frac{1453}{19036} = 7.6\% & \frac{1685}{20915} = 8.1\% \\
\text{Omega plc} & \frac{440}{16320} = 2.7\% & \frac{560}{15260} = 3.7\% & \frac{860}{19540} = 4.4\% \\
\end{array}
\]

The nearest figure to gross profit we can achieve from the data is operating profit and depreciation, so this figure is used in the above calculation.

\[
\begin{array}{c|c|c}
\text{Asset utilization - sales to capital employed} & \text{20X1} & \text{20X2} & \text{20X3} \\
\hline
\text{Alpha plc} & \frac{16929}{4766} = 3.55 & \frac{19036}{5451} = 3.49 & \frac{20915}{7394} = 2.83 \\
\text{Omega plc} & \frac{16320}{7660} = 2.13 & \frac{15260}{7840} = 1.95 & \frac{19540}{9020} = 2.16 \\
\end{array}
\]

Note that capital employed is the figure used in the ROCE calculation less the amount of investments, as sales income is not generated from investments.

\[
\begin{array}{c|c|c}
\text{Stock turnover} & \text{20X2} & \text{20X3} \\
\hline
\text{Alpha plc} & \frac{1265}{19036} = 24 \text{ days} & \frac{1359}{20915} = 23 \text{ days} \\
\text{Omega plc} & \frac{2290}{16320} = 46 \text{ days} & \frac{3160}{19540} = 59 \text{ days} \\
\end{array}
\]

Average stock is used in the above calculation. Stock has to be compared to sales here as we have no information in respect of cost of sales.

\[
\begin{array}{c|c|c}
\text{Debtors’ turnover} & \text{20X1} & \text{20X2} & \text{20X3} \\
\hline
\text{Alpha plc} & \frac{57}{16929} = 1 \text{ day} & \frac{54}{19036} = 1 \text{ day} & \frac{65}{20915} = 1 \text{ day} \\
\text{Omega plc} & \frac{2040}{16320} = 46 \text{ days} & \frac{1920}{15260} = 46 \text{ days} & \frac{2660}{19540} = 50 \text{ days} \\
\end{array}
\]

Note that average debtors figures could have been used in the above calculations.

\[
\begin{array}{c|c|c}
\text{Creditors’ turnover} & \text{20X1} & \text{20X2} & \text{20X3} \\
\hline
\text{Alpha plc} & \frac{1381}{16929} = 30 \text{ days} & \frac{1521}{19036} = 29 \text{ days} & \frac{1651}{20915} = 29 \text{ days} \\
\text{Omega plc} & \frac{1020}{16320} = 23 \text{ days} & \frac{1620}{15260} = 39 \text{ days} & \frac{2700}{19540} = 50 \text{ days} \\
\end{array}
\]
Again average creditors figures could have been used in the above calculations. The sales figures have to be used as we do not have information in respect of cost of sales.

(b) Key ratios to monitor financial statements are as follows:

**Gearing**

<table>
<thead>
<tr>
<th>Year</th>
<th>Numerator</th>
<th>Denominator</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>757</td>
<td>4157</td>
<td>18.2%</td>
</tr>
<tr>
<td>20X2</td>
<td>914</td>
<td>4738</td>
<td>19.3%</td>
</tr>
<tr>
<td>20X3</td>
<td>3534</td>
<td>4094</td>
<td>86.3%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Numerator</th>
<th>Denominator</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>7040</td>
<td>860</td>
<td>818%</td>
</tr>
<tr>
<td>20X2</td>
<td>6980</td>
<td>1140</td>
<td>612%</td>
</tr>
<tr>
<td>20X3</td>
<td>7720</td>
<td>1520</td>
<td>508%</td>
</tr>
</tbody>
</table>

Debt is taken to be preference shares, long-term creditors, provisions, overdraft and short-term loans in the above calculations.

**Current ratio**

<table>
<thead>
<tr>
<th>Year</th>
<th>Numerator</th>
<th>Denominator</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>2017</td>
<td>2749</td>
<td>0.7</td>
</tr>
<tr>
<td>20X2</td>
<td>1978</td>
<td>2943</td>
<td>0.7</td>
</tr>
<tr>
<td>20X3</td>
<td>2567</td>
<td>3472</td>
<td>0.7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Numerator</th>
<th>Denominator</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>8060</td>
<td>3580</td>
<td>2.3</td>
</tr>
<tr>
<td>20X2</td>
<td>8940</td>
<td>3840</td>
<td>2.3</td>
</tr>
<tr>
<td>20X3</td>
<td>11240</td>
<td>5700</td>
<td>2.0</td>
</tr>
</tbody>
</table>

**Acid test**

<table>
<thead>
<tr>
<th>Year</th>
<th>Numerator</th>
<th>Denominator</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>800</td>
<td>2749</td>
<td>0.3</td>
</tr>
<tr>
<td>20X2</td>
<td>666</td>
<td>2943</td>
<td>0.2</td>
</tr>
<tr>
<td>20X3</td>
<td>1162</td>
<td>3472</td>
<td>0.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Numerator</th>
<th>Denominator</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>6020</td>
<td>3580</td>
<td>1.7</td>
</tr>
<tr>
<td>20X2</td>
<td>6400</td>
<td>3840</td>
<td>1.7</td>
</tr>
<tr>
<td>20X3</td>
<td>7460</td>
<td>5700</td>
<td>1.3</td>
</tr>
</tbody>
</table>

(c) The ratio analysis carried out above identifies the following:

- Alpha has a much higher ROCE than Omega, but Alpha’s is falling, whereas Omega is rising.
- Alpha has a higher margin on operating profits than Omega. However, Omega’s has nearly doubled in three years.
- Alpha’s asset utilization is better than Omega’s but Omega’s is rising, whereas Alpha’s is falling.
- Alpha appears to operate almost entirely by cash sales whereas Omega allows 50 days for debtor’s payment.
- Creditor periods are one month for Alpha but two months for Omega. Note Omega’s does not match its credit given period.
- Alpha’s gearing is low when compared to Omega’s, but an increase occurred in 20X3 when preference shares were issued to finance expansion. Omega’s gearing is very highly although it started to fall.
- Not much change has occurred for both companies throughout the period in their liquidity. Alpha’s is lower than Omega’s but as it has been at this low level for three years then one would assume the business is viable. Omega’s liquidity is high and therefore too many resources are tied up in current assets.

Overall Alpha benefits from high margins, high asset turnover and good use of working capital. The preference share issue has increased gearing but this is not a danger levels and could be expected to decrease as profits increase from the additional resources. Omega has low margins and low asset turnover and maintains high working capital in debtors and slow-moving stocks. Omega’s high gearing makes it sensitive to interest changes.

(d) Alpha, given its debtor strategy, high margin and high turnover may well be in the food retailing sector. Omega may be a manufacturer in the engineering industry or something similar.
(e) Improvements to financial statements. We have discussed these throughout this chapter and elsewhere in this book. Summarizing we would suggest that:

- more relevant and reliable information is required that enables predictions to be made
- that historical cost is not a suitable base, deprival value may be more relevant
- that the change in the value of the pound over a period does not permit useful comparisons to be made
- that the information is not timely enough
- that different accounting policies used by companies distort the comparison.

The constraints on the implementation of these improvements are centred around the problems of:

- providing sensitive commercial information within the public domain
- the subjectivity involved in measurement if historical cost is abandoned
- identifying accounting policies that would reflect a true and fair view of the entities
- identifying a conceptual accounting framework.
Chapter 31 Techniques of Financial Analysis

2 (a) Cash is exact, profits are calculated via concepts which permit various interpretations/judgments. Profit is a moving target. Cash balances can be boosted at year end quite easily by withdrawing payments, taking out loans, encouraging by incentives early debtor settlement etc.

(b) Company needs cash flow and profit to survive. Concentration on increasing cash balances is bad policy as the money will not be earning unless it is invested somehow.