Student's Solutions to the Exercises

Chapter 1

☑1 Obviously the scope here is almost endless. Here are three interesting definitions from the USA which students are not very likely to come across (extracted from A.R. Belkaoui (1992) *Accounting Theory*, 3rd edn, Academic Press, London). 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]

More recently, accounting has 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]

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[1] 'Review and resume', Accounting Terminology Bulletin No.1, American Institute of Certified Public
Accounts, New York, 1953, paragraph 5.

[2] American Accounting Association, A Statement of Basic Accounting Theory, American Accounting
Association, Evanston, IL, 1966, p.1.

[3] financial statements of business enterprises', American Institute of Certified Public Accountants, New York, 1970, paragraph 40.

☑ 2 Accounting information is usually mainly past information, but user decisions are by definition future directed. Consider:

- relevance v. reliability
- objectivity v. usefulness
- 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.

☑ 7 It is really much less objective than people often claim. Examples of 'unobjectivity' include:

- problem of determining purchase cost
- overhead allocation
- depreciation calculation
- provisions and their estimation
- prudence (a subjective bias by definition).

Chapter 2

☑ 1 You will notice that 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. If we consider IAS we might argue that IAS is economics based (e.g. substance over 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.

Chapter 3

☑ 1 As so often, this is partly a matter of perception. In theory, the proposition is not correct, for two reasons. The first is that accounting regulation, and accounting practice, in Europe is bound by the contents of European Directives, especially the 4th, for individual companies, and the 7th, for groups. The second is the creation of the endorsement mechanism for emerging IFRSs, described in the text.

Practice, however, seems set to be rather different. It should be remembered that the 4th Directive has been amended to allow consistency with IASB requirements in several respects, notably with regard to the use of fair values. The make-up of the IAS Board is also significant. Perhaps most importantly in practice, the entire IAS Board, including the European representatives, seems united on the broad thrust of developments.

Chapter 4

☑ 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 5

☑ 2 An interesting question. Replacement cost accounting, given rising cost levels, leads to a lower operating profit figure, which is more prudent. It also leads to higher asset figures in the balance sheet, which is *less* prudent. These two effects considered together will lead to much lower profitability and return on resources ratios, which perhaps sounds more prudent! Make them think!

☑ 6 I.M Confused, computer dealer

(a) Historical cost accounting

Profit and loss accounts for the years:

	20X1	*20X2*
	€	€
Sales	3000	3600
Cost of sales	(2000)	(2000)
Gross profit	1000	1600
Expenses - rent	(600)	(700)
Net profit	400	900
Tax @ 50%	(200)	(450)
Retained profit	200	450

Balance sheets at year ends*:*

	20X1		*20X2*	
Inventory		€		€
@ €1000	(4)	4000	(2)	2000
@ €1200	(2)`	2400	(2)	2400
@ €1400	(0)	0	(2)	2800
		6400		7200
Cash		3800		3450
		10200		10650
Capital		10000		10000
Retained profits		200		650
		10200		10650

(b) Replacement cost accounting

Profit and loss accounts for the years:

	20X1	*20X2*
	€	€
Sales	3000	3600
Cost of sales	(2200)	(2600)
Gross profit	800	1000
Expenses - rent	600	700
Operating profit	200	300
Tax paid	200	450
Profit/(loss)	0	(150)
Realized holding gain	(2 100)) 200	(2 x 300) 600
Historical cost profit	200	450

Balance sheets at year ends*:*

	20X1		*20X2*	
Inventory		€		€
@ €1000	(4)	4000	(2)	2000
@ €1200	(2)`	2400	(2)	2400
@ €1400	(0)	0	(2)	2800
		6400		7200
Cash		3800		3450
		10200		10650

Capital	10000	10000
Retained holding gain	200	650
	10200	10800
Distributable profits	0	(150)
Unrealized holding gains	1400	1200
	11600	11850

(c) The figures show that, given an intention to continue the operations of the business at the current level, the historical cost profit figure is entirely mythical - indeed in the second year the business has an operating loss on this basis.

Chapter 6

☑ 3 Arguably, the suggestion would give an income statement with a useful long-run operating perspective (note that this would perhaps be even more relevant if based on future RC rather than on current RC figures!) at the same time as a balance sheet of current cash equivalents, i.e. meaningful current market values. Discuss advantages of both of these. Against this, there would be a loss of internal consistency in the reporting package, which seems significant. Discuss this too.

☑ 6 **Steward plc**

Trading and profit and loss account for the year ended 31 December:

		1		**2**
		€		€
Sales		12000		
Less: cost of sales		8000		
Gross profit		4000		
Expenses	1000		1200	
Depreciation (note (c))	1000		1000	
		2000		2200
		2000		1900
Holding gain (note (d))		1000		2500
		3000		4400

Balance sheet as at 31 December:

	1	**2**
	€	€
Fixed assets		
Machine at NRV (note (a))	9000	8000
Current assets		

Inventory at NRV (note (b))	3000		10000	
Bank	21000		19400	
		24000		29400
		33000		37400
Share capital		30000		30000
Profit for year		3000		7400
		33000		37400

Notes

(a) *Fixed assets*. At the end of each year the machine is brought into the balance sheet at its net realizable value.

(b) *Inventory*. The inventory is also brought into the balance sheet at the end of each year at its net realizable value.

31.12.1200 units x €15 = £3000
31.12.5500 units x €20 = £10000

(c) *Depreciation*. The depreciation is the difference between the NRV of the asset at the end of each year, less the NRV of the asset at the beginning of the year.

Year 1 €9000 - €10000
Year 2 €8000 - €9000

(d) *Holding gain*. In Year 1 the holding gain is the unrealized holding gain on the closing stock:

200 units €5 (i.e. €15 x €10) = €1000

In Year 2 the holding gain of Year 1 has now been realized (and therefore included in the trading account for Year 2) whilst there is an unrealized holding gain on the closing stock of:

500 units x €7 (i.e. €20 - €13) = €3500

Therefore, in Year 2 the holding gain is:

	€
Unrealized holding gain in Year 2	3500
Less unrealized holding gain from Year 1 now realized in Year 2	1000
	2500

If in Year 2 we were to include the €1000 holding gain from Year 1, we would be double counting the holding gain.

Chapter 7

☑ 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.

Chapter 8

☑ 1 There are those who regard it 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 9

☑ 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. Discussion generally.

Chapter 10

☑ 6 This can be answered by determining the advantages and disadvantages of providing additional information.
Advantages:

- promotion of harmony between users and management
- better educated users
- possibly easier change management
- possible influence on users
- users having more relevant information on which to base their decisions.

Disadvantages:

- risk of providing information to competitors
- possibly misleading as they are management opinion of the future in many cases
- not audited
- may not be produced at the appropriate level e.g. plant level, department level
- increases costs.

☑ 7 The answer here is similar to the disadvantages listed in question 6. Overcoming these disadvantages is something entities are currently working on evidenced by moves towards environmental and social report auditing.

Chapter 11

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

ROCE

	Alpha plc	*Omega plc*
20X1	957/4914 = 19.5%	240/7900 = 3.0%
20X2	1209/5652 = 21.4%	360/8120 = 4.4%
20X3	1409/7628 = 18.5%	640/9240 = 6.9%

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 P&L data is not separated into long- and short-term interest payable.

Profit to sales

20X1	1157/16929 = 6.8%	440/16320 = 2.7%
20X2	1453/19036 = 7.6%	560/15260 = 3.7%
20X3	1685/20915 = 8.1%	860/19540 = 4.4%

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.

Asset utilization - sales to capital employed

20X1	16929/4766 = 3.55	16320/7660 = 2.13
20X2	19036/5451 = 3.49	15260/7840 = 1.95

20X3	20915/7394 = 2.83	19540/9020 = 2.16

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.

Stock turnover

20X2	1265/19036 = 24 days	2290/15260 = 54 days
20X3	1359/20915 = 23 days	3160/19540 = 59 days

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.

Debtors' turnover

20X1	57/16929 = 1 day	2040/16320 = 46 days
20X2	54/19036 = 1 day	1920/15260 = 46 days
20X3	65/20915 = 1 day	2660/19540 = 50 days

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

Creditors' turnover

20X1	1381/16929 = 30 days	1020/1630 = 23 days
20X2	1521/19036 = 29 days	1620/15260 = 39 days
20X3	1651/20915 = 29 days	2700/19540 = 50 days

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

20X1	757/4157 = 18.2%	7040/860 = 818%
20X2	914/4738 = 19.3%	6980/1140 = 612%
20X3	3534/4094 = 86.3%	7720/1520 = 508%

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

Current ratio

20X1	2017/2749 = 0.7	8060/3580 = 2.3
20X2	1978/2943 = 0.7	8940/3840 2.3
20X3	2567/3472 = 0.7	11240/5700 = 2.0

Acid test

20X1	800/2749 = 0.3	6020/3580 = 1.7
20X2	666/2943 = 0.2	6400/3840 = 1.7
20X3	1162/3472 = 0.3	7460/5700 = 1.3

(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 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 has 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 12

☑ 6 It certainly seems useful, and consistent, to require the revaluation of land, which, after all, does not depreciate. Such information increases relevance, but arguably at some sacrifice of reliability. Discussion needed.

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

☑ 10

Errsea – income statement extracts year ended 31 March 2007

	$
Loss on disposal of plant – see note below ((90,000 – 60,000) – 12,000)	18,000
Depreciation for year (wkg (i))	75,000
Less: Government grants (wkg (iv))	(19,000)

Note: the repayment of government grant of $3,000 could alternatively have been included as an increase of the loss on disposal of the plant.

Errsea – balance sheet extracts as at 31 March 2007

	cost $	**accumulated depreciation $**	**carrying amount $**
Property, plant and equipment (wkg (v))	360,000	195,000	165,000
Non-current liabilities			
Government grants (wkg (iv))			39,000
Current liabilities			
Government grants (wkg (iv))			27,000

Workings

(i)

Depreciation for year ended 31 March 2007	$
On acquired plant (wkg (ii))	52,500
Other plant (wkg (iii))	22,500
	75,000

(ii) 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.

(iii)

The remaining plant is depreciated at 15% on cost	$
(b/f 240,000 – 90,000 (disposed of) x 15%)	22,500

(iv) Government grants

Transferred to income for the year ended 31 March 2007:	$
From current liability in 2006 (10,000 – 3,000 (repaid))	7,000
From acquired plant (see below):	12,000
	19,000

Non-current liability	$
b/f	30,000
transferred to current	(11,000)
on acquired plant (see below)	20,000
	39,000

Grant on acquired plant is 25% of base cost only = $48,000
This will be treated as:

To income in year ended 31 March 2007 (48,000/3 x 9/12)	12,000
Classified as current liability (48,000/3)	16,000
Classified as a non-current liability (balance)	20,000
	48,000

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

Current liability	
Transferred from non-current (per question)	11,000
On acquired plant (see above)	16,000
	27,000

(v)

	cost $	**accumulated depreciation $**	**carrying amount $**
Property, plant and equipment			
Balances b/f	240,000	180,000	60,000

Disposal	(90,000)	(60,000)	(30,000)
Addition (wkg (ii))	210,000	52,500	157,500
Other plant depreciation for year (wkg (iii))		22,500	(22,500)
Balances at 31 March 2007	360,000	195,000	165,000

Chapter 13

☑ 1 Intuitively, it seems to us that goodwill is an asset. The only difficulty with this, given IASB definitions, is whether or not an enterprise can control goodwill. It certainly can be expected to give benefit.

Chapter 14

☑ 3 The answer is D.

Workings

The overall impairment loss is $2 million [$27 million - $25 million]. This loss is first allocated to the asset that has suffered obvious impairment, leaving the balance of $1 million to be allocated to goodwill.

Chapter 15

☑ 1 Students should be able both to quote the IAS 17 definitions and to explain them in their own words. The essential point is that with a finance base, the lessee is, in substance, in the same business position (but not legal position) as if it had actually bought the item.

☑ 7 (i) The accounting treatment of leases is an example of the application of substance over legal form. If this principle is not followed it can lead to off balance sheet financing. The treatment of a lease is determined by the extent to which party receives the risks and rewards incidental to ownership. If a lease transfers substantially these risks and rewards to the lease it is classed as a finance lease; if not it is an operating lease.

The accounting treatment for the lessee of an operating lease is that the income statement is simply charged with the periodic rentals and there is no effect on the balance sheet other than possibly an accrual or prepayment of the rentals. By contrast a finance lease is treated as a financing arrangement whereby the lessee is treated as having taken out a loan to purchase an asset. This means that both the obligations under the lease and the related

asset are shown on the lessee's balance sheet. The impact on the income statement of treating a finance lease as an operating lease is minimal. Over the life of the lease substantially the same amount would be charged to income, however the inter-period timing of the charges would differ. It is the effect on the balance sheet that is important. Treatment as an operating lease means that neither the asset nor the liability is included on the lessee's balance sheet and this would hide the company's true level of gearing and improve its return on capital employed - these are two important ratios.

The Standard gives examples of situations that would normally lead to a lease being classified as a finance lease:

- the lease transfers the ownership of the asset to the lessee at the end of the lease (in some countries these are described as hire purchase agreements)
- the lessee has the option to purchase the asset (normally at the end of the lease) at a favourable price, such that the option is almost certain to be exercised
- the term of the lease (including any secondary period at a nominal rent) is for the major part of the economic life of the asset
- the present value of the minimum lease payments to substantially the fair value of the asset
- the asset is of such a specialized nature that only the lessee could use it without major modification
- the lease is non-cancellable or only cancellable with a penalty to the lessee
- fluctuations in residual gains or losses fall to the lessee.

(ii)

Gemini - Income statement extracts year to 31 March 2003	$
Depreciation of leased asset (w (i))	48 750
Lease interest expense (w (ii))	12 480
Balance sheet extracts as at 31 March 2003	
Leased asset at cost	260 000
Accumulated depreciation (w (i)	(113 750)
Net book value	146 250
Current liabilities	
Accrued lease interest (w (ii))	12 480
Obligations under finance leases (w (ii))	47 250
Non-current liabilities	
Obligations under finance leases (w (ii))	108 480

Workings

(i) Depreciation for the year ended 31 March 2002 would be $65 000 ($260 000 x 25%)

Depreciation for the year ended 31 March 2003 would be $48 750 (($260 000) - $65000) x 25%)

(ii) The lease obligations are calculated as follows:

Cash price/fair value at 1 April 2001	260 000
Rental 1 April 2001	(60 000)
	20 000
Interest to 31 March 2002 at 8%	16 000
	216 000
Rental 1 April 2002	(60 000)
Capital outstanding 1 April 2002	156 000
Interest to 31 March 2003 at 8%	12 480

Interest expense accrued at 31 March 2003 is $12 480. The total capital amount outstanding at 31 March 2003 is $156 000 (the same as at 1 April 2002 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 12480). This leaves capital of $108 480 (156 000 47250) as a non-current liability.

Chapter 16

☑ 6 IAS 11 assumes that management can always make a judgement on contract costs, estimated costs to completion and the stage of completion, whereas USGAAP assumes there may be circumstances in which this judgement is questionable. We leave the debate to you. It is also worth noting that entities do receive stage payments for contracts and that IAS 11 treats these as income rather than a liability.

Chapter 17

☑ 1 FIs have a significant impact on an enterprise's financial performance, position and cash flow. If these FIs are carried off balance sheet then the movement in the instrument in favour of or against the enterprise can significantly change its risk profile.

☑ 8 Discussion should revolve around the issues of realization and the provision of useful information to users. Whether a gain or loss has to be realized before it is recognized in financial statements is at the heart of this discussion. Note that emphasis is now placed on recognition and measurement with reasonable certainty rather than

realization.

Chapter 18

☑ 1 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.

IAS 18 defines revenue as: 'The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants. (para. 7)

☑ 8 Given that the recognition of revenue requires management to make a number of subjective decisions, it would be difficult to describe it as objective.

☑ 10

(a) In this example we need to consider whether economic benefits, the £0.6m and £0.4m will flow to A entity. There is some uncertainty that this will happen as it is dependent upon Connect receiving the funding and therefore the revenue should not be recognised until the uncertainty surrounding the funding is resolved.

(b) We need to consider here whether economic benefits will flow to A. this will not be settled until negotiations with the insurance company are complete and the amount can then be reliably measured. In this case revenue can only be recognised on completion of the negotiations not on billing.

(c) In this example there are two distinct components, the equipment and maintenance contract. The discount on the dual purchase by the customer is £24 and we can reasonably apportion this £16 to maintenance and £8 to equipment. On delivery of

the equipment Z will recognise £144 as revenue and the remaining £72 will be taken to revenue evenly over the 12-month period. This solution will also be applied to the provision of mobile phones and the monthly service provision contract as long as we can determine stand-alone prices for the components in the mobile phone deal.

(d) A sale has again occurred here of two components. The total package has cost £52 250 (discount £2750). The discount can be apportioned as we did for the broadband supplier, i.e:

Boat

50000/55 000 – 2750 = 2500
thus cost of boat £47 500

Moorings 5000/55 000 –2750 = 250 thus cost of moorings £4750.

The revenue of £47 500 will be recognised on sale of the boat and £4750 for the moorings will be recognised evenly over the year.

OR

The discount can be apportioned based on profit margins:

Boat

(12500/912 500 + 2500) – 2750 = £2290 thus cost of boat £47 710 Moorings 2500/15 000 _ 2750 = £460 thus cost of moorings £4540.

(e) Revenue cannot be recognised as the service provided in this case is uncertain until the outcome of the court case. Revenue will only be recognised if the outcome is a 'win' situation. The outcome of the court case is the 'trigger point' for recognition of revenue, if any is to be.

(f) A to X

A will recognise the revenue of £10 per door from X. If A buys the doors from X he will record the cost in inventory and the subsequent revenue when he sells on to the house builder.

A to Y

The transactions of sale and purchase are linked in

this deal and therefore A should not recognise the £10 revenue on provision of materials to Y but retain the cost of the materials £5 in inventory and record the £10 received from Y as a liability. When the door is repurchased the additional £40 paid by A will be recorded as inventory giving an inventory total of £45. No sale or revenue will be recognised until the door is sold on to the house builder.

(g) Members obtain a £2 discount per visit and over an estimated life of 100 visits this equates to £200. Thus the £50 paid by members on joining over and above the discount can be regarded as revenue at the point of joining. The discount of £200 should be regarded initially as a liability and then spread over the expected two years of active membership probably on a time basis (this is in accordance with IAS 18 appendix, para. 17).

(h) Again the answer to this problem is contained in the appendix to IAS 18 which states that where orders are taken for goods not currently held in inventory revenue cannot be recognised until goods are delivered to the buyer.

(i) Again the answer is contained within IAS 18 appendix, para. 16. Revenue has to be recognised over the period of instruction. This if a student has paid the fee for a three-year course then this fee must be spread over the three years not recognised in full in the first year.

Chapter 19

☑ 6 A provision and a contingent liability have been distinguished throughout the text, so refer to the definitions. 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 balance sheet 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

☑ 4 These are fully explained in the text. You are expected to demonstrate your understanding by the use of examples

similar to but not identical to those used in the text.

☑ 7 You should set your answer out in a clear style covering the following areas:

- 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?

Liability method
Calculates deferred tax on current rate of tax thus showing the best estimate of a future liability. Emphasis on balance sheet.

Deferral method
Calculates deferred tax at the tax rate at date difference arose. The balance on deferred tax account is not affected by change in tax rate. Emphasis on income statement.

The approach adopted by the IASB which clearly opts for a balance sheet view full provisioning where the tax is seen as a liability - not an income statement view which advocates flow-through or at best partial provision. A conclusion to the memo can be formed from questions 1 and 2 and it would be useful to make mention of discounting which reduces the effect of full provisioning.

Chapter 21

☑ 1 In this assignment the terms of the arrangement provide 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 (see discussion of IAS 39); 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.

If we apply this to this assignment, we will start by measuring the fair value of the cash alternative = 3000 - €30 = €90 000. The fair value of the equity alternative is 2 500 - €28 = €70 000. The fair value of the equity component of the compound instrument is a 20 000 (€90 000 - €70 000). This share-based payment transaction will be recorded as C follows. 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:

Year	Calculation	Expense	Equity	Liability
1	Liability component (3000 _ €33)/3 = 33 000 Equity component (20 _ 1/3) = 6 666	39666	6666	33000
2	Liability component (3000 _ €36)2/3 _ 33 000 = 39000 Equity component (20.000 _ 1/3) = 6 666	45666	13332	72000
3	Liability component (3000 _ 40) _ 72 000 = 48 000 Equity component (20 000 _1/3) = 6 667	54667	20000	120000

Suppose that at the end of year 3 the directors choose the cash alternative. In that situation €20 000 will be paid to the directors and the value of the liability will be nil afterwards. The equity component remains unchanged. When the directors choose a payment in shares then 25 000 shares will be issued. The liability amount will be transferred to the equity account.

☑ 2 (a) Defined contribution plans:

These are relatively straightforward plans that do not present any real problems. Normally under such plans employers and employees contribute specified amounts (often based on a percentage of salaries) to a fund. The fund is often managed by a third party. The amount of benefits an employee will eventually receive will depend upon the investment performance of the fund's assets. Thus in such plans the actuarial and investment risks rest with the employee. The accounting treatment of such plans is also straightforward. The cost of the plan to the employer is charged to the income statement on an annual basis and (normally) there is no further on-going liability. This treatment applies the matching concept in that the cost of the post-retirement benefits is charged to the period in which the employer received the benefits from its employee. Postretirement benefits are effectively a form of deferred remuneration.

Defined benefit plans:

These are sometimes referred to as final salary schemes because the benefits that an employee will receive from such plans are related to his/ her salary at the date they retire. For example, employees may receive a pension of 1/60th of their final year's salary for each year they have worked for the company. The majority of defined benefit

plans are funded, i.e. the employer makes cash contributions to a separate fund. The principles of defined benefits plans are simple, the employer has an obligation to pay contracted retirement benefits when an employee eventually retires. This represents a liability. In order to meet this liability the employer makes contributions to a fund to build up assets that will be sufficient to meet the contracted liability. The problems lie in the uncertainty of the future, no one knows what the eventually liability will be, nor how well the fund's investments will perform. To help with these estimates employers make use of actuaries who advise the employers on the cash contribution required to the fund. Ideally the intention is that the fund and the value of the retirement liability should be matched, however, the estimates required are complex and based on many variable estimates, e.g. the future level of salaries and investment gains and losses of the fund. Because of these problems regular actuarial estimates are required and these may reveal fund deficits (where the value of the assets is less than the post-retirement liability) or surpluses. Experience surpluses or deficits will give rise to a revision of the planned future funding. This may be in the form or requiring additional contributions or a reduction or suspension (contribution holiday) of contributions. Under such plans the actuarial risk (that benefits will cost more than expected) and the investment risk (that the assets invested will be insufficient to meet the expected benefits) fall on the company. Also the liability may be negative, in effect an asset.

Accounting treatment:

The objective of the new standard is that the financial statements should reflect and adequately disclose the fair value of the assets and liabilities arising from a company's post-retirement plan and that the cost of providing retirement benefits is charged to the accounting periods in which the benefits are earned by the employees.

In the balance sheet:

An amount should be recognized as a defined benefit liability where the present value of the defined benefit obligations is in excess of the fair value of the plan's assets (in an unfunded scheme there would be no plan assets). This liability will be increased by any unrecognized net actuarial gains (see below).

Where an actuarial gain or loss arises (caused by actual events differing from forecast events), IAS 19 requires a '10% corridor test' to be made. If the gain or loss is within 10% of the greater of the plan's gross assets or gross liabilities then the gain or loss may be recognized (in the income statement) but it is not required to be. Where the

gain or loss exceeds the 10% corridor then the excess has to be recognized in the income statement over the average expected remaining service lives of the employees. The intention of this requirement is to prevent large fluctuations in reported profits due to volatile movements in the actuarial assumptions.

The following items should be recognized in the income statement:

- current service cost (the increase in the plan's liability due to the current year's service from employees)
- interest cost (this is an imputed cost caused by the 'unwinding' of the discounting process; i.e. the liabilities are one year closer to settlement)
- the expected return on plan assets (the increase in the market value
of the plan's assets)
- actuarial gains and losses recognized under the 10% corridor rule
- costs of settlements or curtailments.

(b) Income statement

	$000
Current service cost	160
Interest cost (10% _ 500)	150
Expected return on plan's assets (12% _ 500)	(180)
Recognized actuarial gain in year	(5)
Post-retirement cost in income statement	125

Balance sheet

	$000
Present value of obligation	1750
Fair value of plan's assets	(1650)
100	
Unrecognized actuarial gains (see below)	140
Liability recognized in balanced sheet	240
Movement in unrecognized actuarial gain	
Unrecognized actuarial gain at 1 April 2001	200
Actuarial gain on plan assets (w (i))	10
Actuarial loss on plan liability (w (i))	(65)
Loss recognized (w (ii))	(5)
Unrecognized actuarial gain 31 March 2002	140

Workings:

(i)	Plan assets	Plan liabilities
	$000	$000
Balance 1 April 2001	1500	1500
Current service cost		160
Interest		150
Expected return	180	
Contributions paid	85	
Benefits paid to employees	(125)	(125)

Actuarial gain (balance)	10	
Actuarial loss (balance)	___	65
Balance 31 March 2002	1650	1750

(ii) Net cumulative unrecognized actuarial gains at 1 April 2001 200
10% corridor (10% _ 1 500) 150
Excess 50 /10 years = $5 000 actuarial gain to be recognized.

☑ 3

Year	Calculation	Expense	Equity and cumulative expense
1	(1000 _ 0.85 _ 20)/3	5666	5666
2	(1000 _ 0.88 _ 20)2/3 _ 5	666	6067 11733
3	(10 _ 86 _ 20) _ 11 733	5467	17200

☑ 4 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.

Year	Calculation	Expense	Equity
1	(20000 _ 0.98 _ 48)/3	313600	313600
2	((20 000 _ 0.98 _ 48)2/3) _ 313	600 313600	627200
3	(1000 _ 17 _ 48) _ 627 200	188800	816000

Chapter 22

☑ 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

☑ 5 Statement of cash flow must be looked at together with statement of financial position and statement of 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 are nearly as great as that generated from operations
- capital expenditure and investments have been financed from operations, issued share capital and long-term debt
- minority interest payments and cash from associates can be clearly seen l whether acquisition of subsidiary has had a positive effect on cash flow.

Chapter 24

☑ 1

(a) Basic eps	€
Profit	1 100000
Loan interest	100000
	1 00000
Tax at 35%	350000
	650000
Preference dividends	35000
	615000

eps € 61500000
4000000 €15:4c

(b) Fully diluted eps	€
Profit	1 100000
Loan interest	1 100000
Tax at 35%	385000
	715000
Preference dividends	35000
	680000

Number of shares (conversion) = 4 000 000 + 12 500 - 120

= 5 500 000

Fully diluted eps ¼ 68 000 000
5500000 ¼ 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 balance sheet and income statement 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) this would be an adjusting event - since these structural problems were probably already present at year end

(b) would be a non-adjusting event

(c) there is strong indication that the customer was already unable to pay before the balance sheet date. Therefore, the provision for bad debts should be recognized at balance sheet date

(d) although this might look like an adjusting event, it is not because at year end, the recognition and measurement criteria of IAS 37 were not met..

Chapter 25

☑ 2 This is dealt with in depth within the Chapter.

Chapter 27

☑ 2 Proportional consolidation is explained in the text and amply demonstrated in Activities within Chapter 27. Equity accounting is also explained. Equity accounting is used for the consolidation of an investment in an associated enterprise. Proportional consolidation is the benchmark treatment for the consolidation of jointly controlled entities although an alternative is permitted, equity method.

Chapter 28

☑ 4. Consolidated Statement of financial position as at 30 November 20X3

	$m	Largo $m
Non-current assets		
Tangible non-current assets	665.9	
Intangible non-current assets - brand	7	
Intangible non-current assets - goodwill	80.3	
Investment in associate	12.6	765.8
Current assets		218
Total assets		983.8
Capital and reserves		
Called up share capital		460
Share premium account		264

Accumulated Reserves	121.2
Minority interest	50.6
	895.8
Non-current liabilities	69
Current liabilities	19
	983.8

(i) The business combination should not be accounted for as a uniting of interests because of the following reasons:

(a) the fair value of the net assets of Fusion and Spine ($315 million $119 million) is significantly smaller than those of Largo ($650 million). The employees of Largo number fifty per cent more than the combined total of Fusion and Spine and the market capitalization of Largo is significantly larger than that of the two companies ($644 million, Largo, as against $310 million, Fusion, $130 million Spine, i.e. $440 million).

(b) the new board of directors comprises mainly directors from Largo. (Seven directors out of ten directors sitting on the Board.)

The arguments concerning the equity holdings are not strong enough to override the overwhelming size and control dominance set out above. The business combination should be treated as an acquisition.

(ii) Largo acquired Fusion and Spine on 1 December 20X2 and, therefore, control was gained for the purpose of the group accounts on that day. For the purpose of the Largo Group, the date of acquisition of Spine by Fusion is not relevant.

Shareholdings	Fusion	Spine
Largo	90%	26%
		90% of 60% 80%
Minority Interest	10%	20%

(iii) Equity of Fusion

	Total	Pre-acquisition	Post-acquisition	Minority Interest
Ordinary share capital	110	99		11
Share premium account	20	18		2
Accumulated reserves	138	122.4	1.8	13.8
Fair value	49	44.1		4.9

adjustment (w(vii))				
Adjustment for depreciation (w(vii))	(3.2)		(2.9)	(0.3)
Impairment of brands (w(vi))	(2)		(1.8)	(0.2)
	311.8	283.5	(2.9)	31.2
Cost of investment (w(v))		345		
Goodwill		(61.5)		

Equity of Spine

	Total	Pre-acquisition	Post-acquisition	Minority Interest
Ordinary share capital	50	40		10
Share premium account	10	8		2
Accumulated reserves	35	24	4	7
Fair value adjustment (w(vii))	29	23.2		5.8
Adjustment for depreciation (w(vii))	(1.9)		(1.5)	(0.4)
Cost of investment (w(v))	122.1	95.2	2.5	24.4
		69		
Cost of investment - indirect (90:10)		45		(5)
Goodwill	18.8			19.5

Minority interest is $31.2 m $19.4 m, i.e. $50.6 million.
Goodwill arising on acquisition of (61.5 + 18.8) i.e. $80.3 million.

(iv) Deferred tax and fair values

Deferred tax should be taken into account in calculation of the fair values of the net assets acquired.

The increase in the value of the net assets to bring

them to fair value is attributable to the property. This increase is used to calculate deferred tax which should be deducted from the fair value of the net assets.

The fair value of the net assets should be decreased by the deferred tax on the property.

Fusion
Fair value $330 million (tax $15 million).
Spine
Fair value $128 million ($9 million).
Total increase in deferred tax provision $24 m

(v) Cost of investment:

The group accounts are utilizing acquisition accounting which requires that the consideration should be measured at fair value. Therefore, the cost of the investments in Fusion and Spine should be measured at the market price. The market price on the day of acquisition was $644 million ÷ (460 150 30) i.e. $2.30 per share.

Therefore, the fair value of the consideration is:

	$m
Fusion 150 m $2.30	345
Spine 30 m $2.30	69

The share premium account of Largo will then become:

Balance at 31 May 2004	30
Arising on issue of shares - Fusion	195
- Spine	39
	264

(vi) Brand name IAS22 'Business Combinations' and IAS38 'Intangible assets' require that intangible assets acquired as part of an acquisition should be recognized separately as long as a reliable value can be placed on such assets. There is no option not to show the intangible asset separately under IAS38. In this case the brand can be separately identified and sold. Therefore, it should be shown separately. Also the brand should be reviewed for impairment as its fair value has fallen to $7 million. The brand should, therefore, be reduced to this value and $2 million charged against the income statement.

(vii) Tangible non-current assets

	$m
Largo	329
Fusion	185

Spine	64
Brand	(9)

Fair value adjustment

- Fusion (330 - 110 - 20 - 136)	64	
- Spine (128 - 50 - 10 - 30)	38	
Additional depreciation - Fusion	(3.2)	(increase in fair value $64 m _5%)
- Spine	(1.9)	(increase in fair value $38 m_5%)
	665.9	

(viii) Group reserves

	1$m
Largo	1120
Fusion	1(2.9)
Spine	12.5
	1119.6
Income from associate	11.6
	1121.2

(ix) Micro

When an associate is first acquired, the share of the underlying net assets should be fair valued and goodwill accounted for. This has not been carried out in the case of Micro.

	$m
Fair value of shares at acquisition (40% - $20m)	8
Goodwill	3
Carrying value of investment	11

The investments are to be marked to market by Micro and, therefore, a profit will have arisen during the period of $24 million$20 million, i.e. $4 million. The investment in Micro will, therefore, be stated at (11(40% 4)) million, i.e. $12.6 million.

☑ 9 (a) Consolidated Statement of financial position for Hapsburg as at 31 March 2004:

$000	$000
Non current assets	
Goodwill (16 000 (w (i)))	16000
Property, plant and equipment (41 000 + 34800 + 3750 (w (i)))	79550

Investments:

- in associate (w (iv))	15900	
- ordinary 3 000 + 1500 (fair value increase)	4500	20400
	115950	
Current Assets		
Inventory (9 900 + 4800 - 300 (w (v)))		14400
Trade receivables (13 600 + 8600)	22200	
Cash (1 200 + 3800)	5000	41600
Total assets		57550
Equity and liabilities		
Ordinary share capital (20 000 + 16000 (w (i)))		36000
Reserves:		
Share premium (8 000 + 16000 (w (i)))	24000	
Accumulated profits (w (ii))	12000	36000
		72000
Minority interests (w (iii))		9150
Non-current liabilities		
10% Loan note (16 000 + 4200)	20200	
Deferred consideration (18 000 + 1800 (w (vi)))	19800	
		40000
Current liabilities:		
Trade payables (16 500 + 6900)	23400	
Taxation (9 600 + 3400)	13000	36400
Total equity and liabilities		157550

Note: all working figures in $000.
The 80% (24 m/30 m shares) holding in Sundial is likely to give Hapsburg control and means it is a subsidiary and should be consolidated. The 30% (6 m/20 m shares) holding in Aspen is likely to give Hapsburg influence rather than control and thus it should be equity accounted.

(i)

		Cost of control	
Investments at cost (see below)	50000	Ordinary shares (30 000 - 80%)	24000
		Share premium (2 000 - 80%)	1600
		Pre acq profit (w (ii))	3200
		Fair value adjustments (see below)	5200
		Goodwill	16000
	50000		50000

The purchase consideration for Sundial is $50 million. This is made up of an issue of 16 million shares (24/3 - 2) at $2 each totalling $32 million and deferred consideration of $24 million ($1 per share) which should be discounted to $18 million (24 million $0.75). The share issue should be recorded as $16 million share capital and $16 million share premium.

Fair value adjustments:

IAS22 requires the full fair value adjustment to be recorded with the minority being allocated their share.

Fair value adjustment	Total	group share (80%)	minority (20%)
Property, plant and equipment	5000	4000	1000
Investments	1500	1200	300
	6500	5200	1300

The fair value adjustment of $5 million to plant will be realized evenly over the next four years in the form of additional depreciation at $1.25 million per annum. In the year to 31 March 2004 the effect of this is $1.25 million charged to Sundial's profits (as additional depreciation); and a net of $3.75 million added to the carrying value of the plant.

Goodwill on acquisition of Aspen:

Purchase consideration (6 million - $2.50)		15000
Share capital	20000	
Profits up to acquisition (8 000 - (6000 - 6/12))	5000	
Net assets at date of acquisition	25000 - 30%	(7500)
Difference - goodwill		7500

(ii) Accumulated profits

	Hapsburg	Sundial	Hapsburg	Sundial	
Additional depreciation (w (i))		1250	Per question	10600	8500
URP in	300		Post acq.	2600	

inventory (w (v))			profit		
Unwinding of interest (w (vi))	1800		Share of Aspen's profit (6000 - 6/12 - 30%)	900	
Minority interest ((8 500 - 1250) - 20%)		1450			
Pre-acq profit ((8 500 - 4500) - 80%)		3200			
Post acq profit (4500 - 1250) - 80%)		2600			
Balance c/f	12000				
	14100	8500		14100	8500

(iii)

	Minority interest		
		Ordinary shares (30 000 - 20%)	6000
		Share premium (2 000 - 20%)	400
		Accumulated profits (w (ii))	1450
Balance c/f	9150	Fair value adjustments (w (i))	1300
	9150		9150

(iv) Unrealized profit in inventory

As the transaction is with an associate, only the group share of unrealized profits must be eliminated: $1.6 million - 2.5 million/4 million - 30% = $300 000

(b) In recent years many companies have increasingly conducted large parts of their business by acquiring substantial minority interests in other companies. There are broadly three levels of investment. Below 20% of the equity shares of an investee would normally be classed as an ordinary investment and shown at cost (it is permissible to revalue them to market value) with only the

dividends paid by the investee being included in the income of the investor. A holding of above 50% normally gives control and would create subsidiary company status and consolidation is required. Between these two, in the range of over 20% up to 50%, the investment would normally be deemed to be an associate (note, the level of shareholding is not the only determining criterion). The relevance of this level of shareholding is that it is presumed to give significant influence over the operating and financial policies of the investee (but this presumption can be rebutted). If such an investment were treated as an ordinary investment, the investing company would have the opportunity to manipulate its profit. The most obvious example of this would be by exercising influence over the size of the dividend the associated company paid. This would directly affect the reported profit of the investing company. Also, as companies tend not to distribute all of their earnings as dividends, over time the cost of the investment in the balance sheet may give very little indication of its underlying value. Equity accounting for associated companies is an attempt to remedy these problems. In the income statement any dividends received from an associate are replaced by the investor's share of the associate's results. In the balance sheet the investment is initially recorded at cost and subsequently increased by the investor's share of the retained profits of the associate (any other gains such as the revaluation of the associate's assets would also be included in this process). This treatment means that the investor would show the same profit irrespective of the size of the dividend paid by the associate and the balance sheet more closely reflects the worth of the investment.

The problem of off balance sheet finance relates to the fact that it is the net assets that are shown in the investor's balance sheet. Any share of the associate's liabilities is effectively hidden because they have been offset against the associate's assets. As a simple example, say a holding company owned 100% of another company that had assets of $100 million and debt of $80 million, both the assets and the debt would appear on the consolidated balance sheet. Whereas if this single investment was replaced by owning 50% each of two companies that had the same balance sheets (i.e. $100 million assets and $80 million debt), then under equity accounting only $20 million ((100 -80) 50% -2) of net assets would appear on the balance sheet thus hiding the $80 million of debt. Because of this problem, it has been suggested that proportionate consolidation is a better method of accounting for associated companies, as both assets and debts would be included in the investor's balance sheet. IAS 28 'Accounting for Investments in Associates' does not permit the use of proportionate consolidation of associates, however IAS 31 'Financial

Reporting of Interests in Joint Ventures' sets as its benchmark proportionate consolidation for jointly controlled entities (equity accounting is the allowed alternative).

Chapter 29

☑ 3. With the temporal method exchange gains and losses are put through the income statement; unrealized gains are the problem. With the closing rate method exchange gains and losses are put through reserves as exchange rate changes will have no effect on cash flow to the holding company. This avoids distortion of income statement due to factors unrelated to trading performance. Losses are the problem with this method.

☑ 5 Critical appraisal is required of the concept behind closing rate as compared with temporal method.

The closing rate is based on the idea that the holding company has a net investment in the foreign operation and that what is at a risk from currency fluctuations is the net financial investment. The temporal method is based on the idea that the foreign operations are simply a part of the group, that is, the reporting entity. Thus the closing rate method assumes that business is carried on overseas by semi-independent units that are dependent on the local currencies, whereas the temporal method assumes overseas units are extensions of the home business. The mode of business operation requires assessment to determine which method of translation should be used and the factors involved in this assessment are detailed in the regulations of IAS 21, which are covered in the text.

Chapter 31

☑ 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.