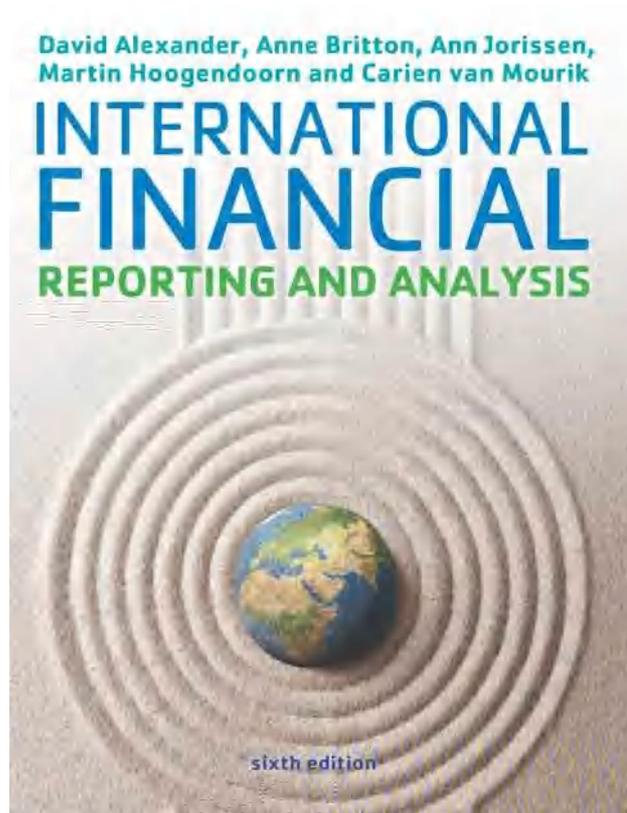


**International Financial Reporting and Analysis,
6th edition**

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

Solutions Manual



Solutions to the Exercises

Answers marked can also be found on the Student side of the website.

Chapter 1 Basics of Financial Reporting

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

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

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.

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(b) danger of confusion and the difficulties of user education.

4–6 We suggest that these three questions are treated as a set. There is scope for wide differences of view and considerable debate. We suspect that objectivity and prudence are likely to come higher up the ‘importance’ scale than they are up the ‘useful’ scale. This would lead to discussion of whether the user or the producer matters more!

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).

8 Completeness requires the inclusion of all relevant contents. The monetary measurement convention requires that which is not measurable be not recorded, even if it is clearly relevant. Discuss conflict.

9 The basic issue is matching (which says capitalize) v. prudence (which says write off as expense at once). Relevance, usefulness, etc. should again be brought out.

10 The more obvious conventions seem to be:

- monetary measurement
- historical cost
- prudence (i.e. lower of cost and NRV)
- realization (profits not realized until ‘sold’).

11 Historical cost accounts are certainly not very objective (see question 7). Analytically, they are not very useful - out of date, stewardship rather than forward-looking decision making etc. But people do accept them and use them, better the devil you know ... etc.,

12 How prudent is prudent? (Again, this is a relative, not an absolute, term.) The normal accounting practice of revenue recognition is not the most prudent possible. Stating debtors at cost (i.e. not recognizing any profits until cash receipts are in) would be both feasible and more prudent than normal practice. Perhaps the normal practice suggests that accountants are ‘reasonably’ prudent (whatever ‘reasonably’ means!).

13–15 We suggest treating these three questions as a set. See discussion in the text. The whole process is subjective in principle and often arbitrary in practice (e.g. the date the invoice happened to get typed); the answer to question 15 is surely ‘no’.

16 This is about the balance sheet equation: resources equals claims. Revenue recognition increases claims (i.e. profits) and therefore increases resources; for example, inventory at cost may be replaced by debtors at selling price.

17 (a) (i) Receipts €90	Payments €42	Surplus €48
(ii) Revenue €60	Expenses €36	Surplus €24

(b) Receipts and payments basis is easier, more objective and makes fewer, possibly risky, assumptions about the future. Revenue and expense basis follows matching convention, is more realistic and is a better measure of economic progress.

Discussion required. Difficulties are the treatment of subscriptions still unreceived for 20X8 and the corresponding 60% expense.

Chapter 2 International Accounting Differences

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.

3 Check for your own country:

- elements of the accounting environment
- the major sources of finance
- whether there is an active and important stock exchange
- is the legal system in your country more inspired by the common law system or the code law system. Did these systems 'originate' in your country or were they 'exported' to your country?
- the relation between accounting and taxation. Is taxable income in your country to a large extent determined by accounting income?
- elements of the accounting system
- sources of accounting regulation
- development of the accounting profession.

The importance of the different elements related to the accounting environment will differ in each country. Try to appraise the importance of these elements in your own country. If you list the important elements, you will be able to understand better your own national accounting standards and national reporting practices.

4 The cultural values that depict a country lie between the following extremes:

- individualism/collectivism
- large v. small power distance
- strong v. weak uncertainty
- masculinity v. femininity.

Appraise where your country is situated with regard to those four constructs. Make use of the explanations of the constructs given on page 26.

5 Changes in the accounting system could point to:

- changes in the standard-setting process, e.g. more input from the private sector or vice versa
- an evolution in the contents of the national GAAP (e.g. a move towards substance instead of legal form)
- changes in the organization of the accounting.

These changes could be driven by several possible forces.

For example:

- changes in the national accounting environment.
- changes in finance patterns, e.g. more companies become listed or go for multi-listings
- relation between accounting income and taxable income changes due to changes enacted by the government
- pressures from the business community
- changes introduced by EU legislation or other national legislation.

6 Gray's adaptation of Hofstede's cultural values is presented on page 30. The four accounting constructs are defined as follows:

- professionalism/statutory control
- investigate how corporate control and external control or audit are organized in your country
- uniformity v. flexibility
- appraise whether your national GAAP are rather uniform or do they allow many recognition and measurement alternatives? Do accounting regulations or standards in your country consist of detailed rules or do they comprise general principles?
- conservatism/optimism
- what are the important stakeholders in your country with regard to financial reporting (shareholders/creditors, the government?)
- how important is the prudence or the conservatism principle in your country?
- secrecy v. transparency
- appraise the disclosure levels of companies in your own country with disclosure levels of companies in other countries. Assess whether access to financial statements of companies is easy in your country. Do interested parties have to contact the company or are financial statements easily accessible with the use of organized databases?

7 This question builds on question 6. The construct secrecy v. transparency will, to a certain extent, explain the differences in levels of voluntary disclosure between different countries.

8 In different accounting journals (e.g. Journal of Accounting and Economics, Journal of Accounting Research, Accounting Review, Abacus, European Accounting Review, Accounting and Business Research) you will find articles which analyse whether or not accounting quality improves after the IFRS adoption. You will notice that the results will be different according to the characteristics of the research population (having adopted IFRS before on a voluntary basis), country differences etc.

9 The financial reporting infrastructure of a country is determined by the existing legal system, the organization of the accounting and audit profession, the risk of litigation, the degree of enforcement, the link between accounting and taxation and other variables discussed in chapter 2. These variables have an impact on the quality of the IFRS accounts.

- * in case of low risk of litigation or low degree of enforcement, the quality of IFRS accounts might be lower

- * the cultural values, in countries characterized by optimism, IFRS GAAP will be applied in a less conservative way. Although IFRS in itself does not pursue conservatism.

- * in countries characterized by more professional than statutory control, preparers and accountants and auditors will rely more on their own judgment for the preparation and the audit of the annual accounts. In countries characterized by statutory control, one will seek for more interpretations of IFRS which will then be complied with in a “detailed legalistic way”.

Chapter 3 The Process of Harmonization

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.

2 Different views are likely here. Arguably, the statement is true, but one-sided, i.e. the IASB has also given the European Commission a formal continuing role in accounting standards creation that market forces could have removed from it.

3 There is much evidence broadly to support this proposition. The complexity of much Standard requirement, as Parts II and III show, is clearly designed for

sophisticated (and wealthy) uses. The IASB is addressing the issue of accounting for small and medium enterprises (SMEs), but it is not obvious that either SMEs or developing country needs have a high priority at the time of writing. Personally, we would regard this as a weakness.

4 These steps the IASB has to follow when issuing a standard – these are compulsory steps:

- Consulting the IFRS Advisory Council about the advisability of adding the topic to the IASB's agenda
- Publishing for public comment an exposure draft approved by at least nine votes of the IASB, including any dissenting opinions held by IASB members
- Consideration of all comments received within the comment period on discussion documents and exposure drafts
- Approval of a standard by at least nine votes of the IASB and inclusion in the published standard of any dissenting opinions

(Source: see preface to the IFRSs – due process – International Financial Reporting Standards)

5. The Monitoring Board was installed in 2009 to enhance the organization's public accountability by establishing a link to a Monitoring Board of Public Authorities. Through the Monitoring Board securities regulators that allow or require the use of IFRS in their jurisdictions will be able to more effectively carry out their mandates regarding investor protection, market integrity and capital information. The Monitoring Board's main responsibilities are to ensure that the Trustees continue to discharge their duties as defined by the IFRS Foundation Constitution, as well as approving the appointment or reappointment of Trustees. It is envisaged that the Monitoring Board will meet the Trustees at least once a year, or more if appropriate.

Chapter 4 Economic Valuation Concepts

1 The detail will obviously depend on the examples chosen. Fixed assets are likely to be all at cost, or partly at cost, with some at valuation; buildings etc. may or may not be depreciated; inventory will be basically at cost; debtors are at net realizable value. There is certainly no proper additivity in a mathematical sense.

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.

4 Outlined and discussed in the text.

(a) Fisher's thinking is discussed on pages 69-72.

(b) Hick's thinking is discussed on page 72-76.

(c) To summarise, for Fisher income is equal to consumption whereas for Hicks income is equal to consumption plus saving, where saving is defined as the difference in value of capital from the beginning of a period to the end. In essence, while Fisher is concerned purely with the individual's enjoyment of consumption, Hicks is more concerned with the *capacity* to consume by building in to the model the concept of capital maintenance or savings. Hicks' conception is therefore a more useful long term concept in the real world. Hicks' views take into account that we live in an uncertain world where market values can change. Income should only be enjoyed after we have maintained capital. Fisher's is an idealised concept of a certain world where capital maintenance is not an issue.

5 For the principles, see text. Income ex ante is calculated with expectations of the beginning of the period and income ex post is calculated with expectations of the end of the period, but both are essentially subjective as they are based on expectation to infinity (subject to materiality!).

6 Viewed as a reporting mechanism, economic income is certainly unattainable except under a multitude of subjective assumptions. Is it ideal? Theoretically, it seems to have a lot going for it, unless we argue that the real 'ideal' is Fisher with his psychic satisfaction - and this is obviously even more 'unattainable' as a measurement and reporting basis.

7 (i) Value of business at beginning of Year 1 (€):

$$\begin{array}{r} \underline{400} \\ 1.1 \end{array} \quad \begin{array}{r} \underline{500} \\ (1.1)^2 \end{array} \quad \begin{array}{r} \underline{1000} \\ (1.1)^3 \end{array} \quad 1528$$

(ii) Value of business at beginning of Year 2 (€):

$$\begin{array}{r} \underline{500} \\ (1.1) \end{array} \quad \begin{array}{r} \underline{1000} \\ (1.1)^2 \end{array} \quad 1281$$

(iii) Value of business at beginning of Year 3 (€):

$$\begin{array}{r} \underline{1000} \\ (1.1) \end{array} \quad 909$$

(iv) Economic income (€):

Year 1	1281	1528	400	153
Year 2	909	1281	500	128
Year 3	0	909	1000	91

Year	Value of business at beginning of year	Economic income for year
1	1528(1)	153(4)
2	1281(2)	128(4)
3	909(3)	91(4)
4	0	0

Year	Cash received in year	Economic income for year	Difference	Cumulative difference	Cumulative difference reinvested 10%	Ideal economic income
Year	€	€	€	€	€	€
1	400	153	247	247	-	153
2	500	128	372	619	25	153
3	1000	91	909	1528	62	153
4	-	-	-	1528	153	153

Chapter 5 Current Entry Value

1 For explanation and illustration, see text. The key point is that replacement cost accounting splits up the historical cost profit into two different elements: the current operating profit and the holding gains. These elements have different causes and different effects and reporting the split facilitates separate analysis and interpretation.

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!

3 Try and encourage an open discussion from students first. It all depends on the chosen capital maintenance concept. Realized gains follow a transaction, so, for example, the holding gain on stock already sold is realized.

Holding gains are only part of profit after capital (as defined) has been maintained. Given an RC-based concept of capital maintenance, holding gains are a capital maintenance adjustment and therefore not part of profit at all, so they could not *logically* be distributable even if they realized and *legally* distributable.

4 The rationale for this proposition is that the holding gains element of historical cost profit is removed, leaving a current operating profit, which genuinely contains only the results of *operations*. Arguably, this is a better indication of repeatable performance. At minimum, the two elements of historical cost profit are separated and can be analysed separately for trends as required.

5 Any cost-based balance sheet is not designed to show meaningful values of most of the items. Perhaps at minimum, however, a replacement cost balance sheet can be said to contain up-to-date estimates of future costs, whereas a historical cost balance sheet contains out-of-date elements of future costs. There is scope for some discussion.

- 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	<u>(2000)</u>	<u>(2000)</u>
Gross profit	1000	1600
Expenses - rent	<u>(600)</u>	<u>(700)</u>
Net profit	400	900
Tax @ 50%	<u>(200)</u>	<u>(450)</u>
Retained profit	<u>200</u>	<u>450</u>

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	<u>200</u>	<u>650</u>
	<u>10200</u>	<u>10650</u>

- (b) Replacement cost accounting

Profit and loss accounts for the years:

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

Historical cost profit		<u>200</u>		<u>450</u>
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		<u>200</u>		<u>650</u>
		<u>10200</u>		<u>10800</u>
Distributable profits		0		(150)
Unrealized holding gains		<u>1400</u>		<u>1200</u>
		<u>11600</u>		<u>11850</u>

(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.

7 Mallard Ltd

(i) *Balance sheet as at 31 December 20X1*

	€	€		€	€
Fixed assets	12600		Shareholders' interest		
Less: depreciation	<u>1260</u>		Shares		10000
		11340	Profit		(20)
Current assets			Holding gains	3600	
Inventory	4000			<u>950</u>	<u>4550</u>
Cash	10000				
	8000				
	47900				
	(9000)				
	(35550)		Current liabilities		
	(13200)	<u>8150</u>	Creditors		<u>960</u>
		<u>12150</u>			
		<u>23490</u>			<u>23490</u>
<i>Trading and profit and loss account for the year to 31 December 20X1</i>					
	€	€		€	€
Purchases	8000		Sales		7200
	8250				10800
	8500				15600
	10800	35550			<u>14300</u>
Holding gains		<u>950</u>			
		36500			

Closing inventory (40 x 100)	<u>(4000)</u>		
	32500		
<i>Gross profit</i>	<u>15400</u>		
	<u>47900</u>		<u>47900</u>
General expenses	13200	<i>Gross profit</i>	15400
Loan in interest	960		
Depreciation	<u>1260</u>	<i>Net loss</i>	<u>20</u>
	<u>15420</u>		<u>15420</u>

(ii)

1 Mar	$100 - 60 = 40 \times (-5)$	= (200)
1 Jun	$210 - 150 = 60 \times 10$	= 600
1 Sep	$310 - 280 = 30 \times 5$	= 150
1 Dec	$432 - 390 = 40 \times 10$	= <u>400</u>
		<u>950</u>

8 (a) (i) Historic cost

	L	H
	€	€
Profit calculations		
Sales (110 + 120 + 130)	360	0
Cost of Sales (100 + 100 + 120)	<u>330</u>	<u>0</u>
Profit	<u>30</u>	<u>0</u>
<i>Balance sheets 30 September</i>		
Inventory	<u>130</u>	<u>100</u>
	€	€
Capital	100	<u>100</u>
Profit	<u>30</u>	
	<u>130</u>	

(ii) Replacement cost

Profit calculations		
Sales (110 + 120 + 130)	360	0
Cost of Sales (100 + 100 + 120)	<u>360</u>	<u>0</u>
Profit	<u>0</u>	<u>0</u>
<i>Balance sheets 30 September</i>		
Inventory	<u>130</u>	<u>100</u>
Capital	100	<u>100</u>
Holdings gain (3 x 10)	<u>30</u>	(1 x 30) 30
	<u>130</u>	<u>130</u>

(b) Discussion required. Physically they are in identical positions: €100 invested, no cash, no drawings, 1 widget. Economically speaking, therefore, if they started in identical positions, and ended in identical positions, we must expect identical

results for both L and H. Replacement cost achieves this and historic cost does not.

Chapter 6 Current Exit Value and Mixed Values

1 This should lead to a discussion based on student proposals. It may be a good idea to get students to present their examples to their colleagues. The major difficulty will be to avoid the double counting of realized gains that have already been included as unrealized ones.

2 Again, student presentation would be useful, with discussion. Detail is a matter of following the logic of the figures, as in the example in the text.

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.

4 It can be argued that a problem with RC accounting is that it uses RC figures in circumstances where an asset would not, or even could not, be replaced. Deprival value certainly removes this criticism, as it only reduces to the RC number when the asset would rationally be replaced. Against this, deprival value introduces more complexity and more subjectivity. Discussion of pros and cons required.

5 (a) The amount of the loss a rationally acting owner would suffer if deprived of an asset.

(b)

	RC €000	NRV €000	EV €000	Deprival value
1	8	10	12	RC
2	8	12	10	RC
3	10	8	12	RC
4	10	12	8	RC
5	12	8	10	EV
6	12	10	8	NRV

(c) Follow the logic through, perhaps with reference to Figure 6.1.

6 Steward plc

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

	1	2
	€	€
Sales	12000	
Less: cost of sales	<u>8000</u>	
Gross profit	4000	

Expenses	1000	1200
Depreciation (note (c))	<u>1000</u>	<u>1000</u>
	<u>2000</u>	<u>2200</u>
	2000	1900
Holding gain (note (d))	<u>1000</u>	<u>2500</u>
	<u>3000</u>	<u>4400</u>

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	<u>21000</u>	<u>19400</u>	
	<u>24000</u>		<u>29400</u>
	<u>33000</u>		<u>37400</u>
Share capital	30000		30000
Profit for year	<u>3000</u>		<u>7400</u>
	<u>33000</u>		<u>37400</u>

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
	<u>2500</u>

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

7

	Stan €	Oliver €
(a) Historic cost		
Capital	100	100
Profit	<u>80</u>	-
	<u>180</u>	<u>100</u>
Inventory	130	100
Cash	<u>50</u>	-
	<u>180</u>	<u>100</u>
(b) Replacement cost		
Capital	100	100
Profit	50	-
Holding gains	<u>30</u>	<u>30</u>
	<u>180</u>	<u>130</u>
Inventory	130	130
Cash	<u>50</u>	-
	<u>180</u>	<u>130</u>
(c) Net realizable value		
Capital	100	100
Profit - realized	80	-
- unrealized	<u>30</u>	<u>60</u>
	<u>210</u>	<u>160</u>
Inventory	160	160
Cash	<u>50</u>	-
	<u>210</u>	<u>160</u>

Workings

	Stan		Oliver	
Historic cost	Cash		Inventory	Profit
1 Jan	100		-	-
1 Jan	-		100	-

31 Mar	130	-	30
1 Apr	15	115	30
30 Jun	155	-	55
1 Jul	30	125	55
29 Sep	180	-	80
30 Sep	50	130	80

Replacement cost	Cash	Inventory	Profit	HG	Cash	Inventory	Profit	HG
	€	€	€	€	€	€	€	€
1 Jan	100	-	-	-	100	-	-	-
1 Jan	-	100	-	-	-	100	-	-
31 Mar	130	-	15	15	-	115	-	15
1 Apr	15	115	15	15	-	-	-	-
Net realizable value	Cash	Inventory	P-R	P-Inr	Cash	Inventory	P-R	P-Unr
	€	€	€	€	€	€	€	€
1 Jan	100	-	-	-	100	-	-	-
1 Jan	-	120)	-	20	-	120	-	20
31 Mar	130	-	30	-	-	130	-	30
	115							
1 Apr	15	130)	30	15	-	-	-	-
	15							
30 Jun	155	-	55	-	-	140	-	40
	125							
1 Jul	30	140)	55	15	-	-	-	-
	15							
29 Sep	180	-	80	-	-	150	-	50
	130							
30 Sep	50	160)	80	30	-	160	-	60
	30							
30 Jun	155	-	30	25	-	125	-	25
1 Jul	30	125	30	25	-	-	-	-
29 Sep	180	-	50	30	-	130	-	30
30 Sep	50	130	50	30	-	-	-	-

Chapter 7 Current Purchasing Power 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 Note the generality of the wording of the question - no particular valuation mechanism is mentioned. Perhaps, as authors and teachers, we should not give our own views. With the right group of students this could make a good discussion or even formal debate. In the end it may come back to relevance v. reliability. Is a general index relevant to anybody or anything?

3 Tricky! The figure is, perhaps, the original monetary investment re-expressed in current purchasing power euros. It tells us the number of today's euro equivalent to our original investment in terms of our spending power as an average family spending unit (which we are not).

4 The essential point is very simple. Current purchasing adjustments to historical cost figures do not lead to any kind of valuation in the proper sense of the word. They show outdated costs, re-expressed (but not re-measured) in terms of current monetary units.

5 Whether they are simple to apply is an open question. Once the index is chosen, the adjustments are, in a sense, objective. In our experience, however, they are certainly hard to explain and interpret. The concept of an ever flexible and variable euro is not an easy one.

6 STAGE 1

Convert the historical cost figures at the beginning of the year into euros of current purchasing power at the beginning of the year.

		31 December Year 7
		€C 000
<i>Fixed assets</i>		
Cost	500 X 220/180	611
Less: depreciation	300 X 220/180	<u>366</u>
<i>Current assets</i>		245
Inventory	100 X 220/215	102
Debtors		200
Bank		<u>150</u>
		<u>452</u>
Less:		
<i>Current liabilities</i>		
Creditors		<u>300</u>
		<u>152</u>
<i>Share capital and P & L (balancing figure)</i>		<u>397</u>

STAGE 2

Convert the historical figures at the end of the year into euros of current purchasing power at the end of the year.

		31 December Year 8
		€C 000
<i>Fixed assets</i>		
Cost	500 X 240/180	666
Depreciation	400 X 240/180	<u>533</u>
<i>Current assets</i>		133
Inventory	150 X 240/235	153
Debtors		300

Bank	<u>350</u>	
	<u>803</u>	
Less:		
<i>Current liabilities</i>		
Creditors	<u>400</u>	<u>403</u>
<i>Share capital and P & L</i> <i>(balancing figure)</i>		<u>536</u>

STAGE 3

Update the share capital and P & L figure calculated in Stage 1 from 31 December in year 7 euros of current purchasing power into 31 December year 8 euros of purchasing power.

	31 December Year 8
	€C 000
Share capital and P & L $397 \times 240/220$	<u>433</u>
Profit for year of £536 000 - €433000 = €103000	

STAGE 4

Let us now prepare the profit and loss account for the year ended 31 December year 8

		<i>Historical cost</i> €000	<i>CPP</i> €C 000
Sales	1850	x 240/230	1931
Cost of goods sold			
Opening inventory	100	x 240/215	112
Purchases	<u>1350</u>	x 240/230	<u>1409</u>
	1450		1521
Less: closing inventory	<u>150</u>	x 240/235	<u>153</u>
	<u>1300</u>		<u>1368</u>
Gross profit	550		563
Expenses	300	x 240/230	313
Depreciation	100	x 240/180	133
Loss on net monetary items	-	(see note)	<u>14</u>
	<u>400</u>		<u>460</u>
Net profit	<u>150</u>		<u>103</u>

The loss on net monetary items is calculated as follows:

	€000
Net monetary items 31.12.7	50
Net monetary items 31.12.8	<u>250</u>
	<u>200</u>

Since 50 has been held throughout the year this represents a purchasing power loss of:

$$50 \times \frac{20}{220} = 5$$

The increase of 200 is assumed to have accrued evenly throughout the year and therefore represents a purchasing power loss of:

$$200 \times \frac{10}{230} = \frac{9}{14}$$

7. Note first of all that a report in general terms is required. It should be in report form, and should consist of narrative, perhaps with small numerical illustrations. The question does not ask for an emphasis on calculation.

Probably the best way to proceed is to outline the principles and summary effects of each method: replacement cost and general inflation adjustments. The first attempts to match current expense levels with current benefit levels, arguably improving the quality of 'matching', and logically moving towards a profit figure relevant to the long-run operating capital maintenance. The second adjusts the measuring (currency) unit for the effects of changes in the general (usually retail) spending power of the relevant currency/economy, and does not give either current entry or current exit prices. They can be combined, producing results probably of excessive complexity.

A good answer will now address the specifics of the situation given. It is noteworthy that the specific indices are increasing faster than the general index. This is particularly true of the machinery index. Dividends may need to be reduced in order to retain funds for expensive future replacements merely to retain the existing scale of operations. This is what operating capital maintenance means! The company has no debt financing, so could easily borrow to finance either dividends or asset replacement, as required, but this is surely a short-termist philosophy. Note as an aside that the legality of dividend payments maxima may, or may not, be affected by the accounting treatments discussed. This is a matter for legal parameters which will be unique to each different jurisdiction.

Perhaps a recommendation would be good. This is likely to be affected by the views and prejudices of the reader.

Chapter 8 Fair Values

1. Fair value is defined and discussed in the text. But in detail it is not so easy to understand, and has been interpreted in different ways at different times. Broadly speaking it is the market selling price in an active market, or a calculated approximation thereto. Whether it is a good idea is to be debated. It depends essentially on the needs of a particular user. It certainly contains information which has economic messages. It certainly is not the answer to everyone's needs. Open discussion.
2. Indeed, discuss! The propositions seem to us to have some sense.
3. Again, discuss. In analytical logic, historical cost is not defensible for investor reporting. But where objectivity is more important than economic relevance (taxation for example) then it may indeed be 'best'. Open discussion including user considerations.
4. Really a repeat of the earlier questions. It all comes back to the user characteristics and individual needs.

Chapter 9 Accounting Theory and Conceptual Frameworks

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.

3 Scope for debate here, of course. Briefly, major points would seem to be the following.

- It provides consistent definitions and relevant considerations, which can help provide consistent and related approaches in particular standards.
- Part of it is out of date and does not adequately reflect current thinking.
- It suggests outcomes which do not always seem intuitively sensible or useful (and are not always followed in Standards, for example a deferred government grant is not a liability, but this is allowed by the relevant Standard at the time of writing). It could be improved by updating and developing certain issues, notably the concept of fair value, which essentially post-dates 1989 and, further, is not

treated consistently across recent Standards. Whether the way in which revenues and expenses are defined in a manner secondary to the definitions of balance sheet items, rather than the other way round, remains a debatable point.

4 This relates to the so-called 'cookbook' approach. IASB Standards claim to be principles based, rather than seeking to cover all eventualities, although this claim is not always justified. The collapse of Enron has given a boost to the idea of principles-based regulations, even in the USA. However, fundamental traditions and attitudes to law, life and regulation are involved here.

5 We guess not, except possibly as regards attitudes to the importance, or otherwise, of prudence.

Chapter 10 Structure of Published Financial Statements

1 There are several reasons why fixed formats can be helpful, provided that additional subsets of data can be inserted when unusual situations require it. It facilitates comparison and analysis and reduces the risk of non-specialists being deliberately confused by unusual presentations. The reason why several different formats are allowed, and are frequently found, is essentially historical. National norms, often related to original user needs and attitudes, are still important.

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.

3 There is evidence that such an assumption is not valid. But this leads to a more fundamental question, i.e. who are the financial statements prepared for - experts or the mass public? Experts can certainly be assumed to understand the intricate nuances of detailed accounting notes.

4 The essential point is to distinguish normal earnings from other increases in ownership equity. The IASB has been having considerable trouble in arriving at a coherent policy for distinguishing exactly where on the spectrum on normality and repeatability, particular types of transaction lie and the process is not complete. Students should comment on the readability and usefulness of the particular presentations which they find in looking at different countries, attempting to take the viewpoint of a genuine user of the financial statements.

Chapter 11 Corporate Governance, Corporate Social Responsibility and Ethics

1 Your answer to this will obviously depend on which enterprise you choose. Assess the information provided by the enterprise in terms of the qualitative characteristics of useful information in the IASB Conceptual Framework.

You should also assess the usefulness of any additional information provided by the enterprise in the annual report, such as environmental information and forecasts. The question is also not specific about which user, so you will have to assess the information from the position of various users.

2 As a potential shareholder you would probably be seeking information on the future prospects of the enterprise so that you can assess the potential for growth in your investment, both revenue and capital wise. Performance indicators such as those provided under 'intellectual capital accounting' would enable you to make a more detailed assessment of performance both internally and externally. Depending on your own personal agenda, you might wish to seek information such as that provided in 'social corporate reports'. Added value statements will also provide you with an at-a-glance review of how the earnings of the enterprise are divided between shareholders, employers, government and internal reinvestment.

3 The value added statement shows that a very high proportion (77%) of the earnings was distributed to employees and that shareholders had a limited share, although this was higher than that retained in the business. The payment to lenders was relatively low, so we could perhaps conclude that the business was fairly low geared but for a proper assessment of this we would need to look at gearing ratios. The performance of the enterprise had only slightly improved on that of the previous year, growing by only 0.4%, but this had been achieved in a climate of increased cost of materials and a steep increase in depreciation charges. It is possible that the enterprise had revalued its fixed assets or that it had increased its fixed assets through purchase/acquisition the previous year and the depreciation was only coming into full effect in 2001. It is, of course, very dangerous to draw any conclusions from just one statement provided by the enterprise and the value added statement must be assessed along with all other information.

4 The answer depends on which enterprise is chosen. Employees will be seeking information on future plans, as they are concerned with job security, continuation of a rising wage/salary to combat the effects of inflation on their personal finances, profit sharing.

Examples are:

- state of the firm's order book
- earnings per share and price earnings ratio
- value added statements
- details of profit-sharing schemes
- forecasts of future capital expenditure
- future plans for:
 - growth or retrenchment
 - acquisition or disposal
 - any moves towards further reduction in employee numbers etc.

5 The appraisal should be made from the aspect of placing reliance on the information provided. The annual financial statements are accompanied by an

auditor's statement attesting to the truth and fairness of the information. The additional information is not subject to the same statement. You have to judge whether the information provided would be misleading without this auditor's statement.

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.

8 Financial reporting is about providing useful information to users for them to make decisions. This must involve more than numbers or the decisions taken will be flawed.

9 Deliverable:

- statement of environmental objectives and aims
- compliance or not with company targets
- environmental expenditure, e.g. waste collection
- contingent liabilities
- environmental audit.

Desirable:

- prospective environmental expenditure on segmental basis
- value-for-money data.

Never deliverable:

- financial consequences of becoming an environmentally sustainable company
- effects of environmental expenditure on share price etc.

10 The student should detail the development of CG from the Cadbury Report through to the 2012 UK Corporate Governance Code and the UK Stewardship Code. Whether the reports and codes have improved CG over time is a matter of opinion. Students should comment on the economic world crisis of 2008 and whether, even with further reporting requirements and more detailed disclosures, this crisis would have been avoided or minimised. The reports and codes have to some extent increased disclosure and the transparency of strategic decisions,

internal controls and risk management but many would agree there is still a long way to go to meet the needs of stakeholders in the 21st century. It is also possible for businesses to presently pay lip service to the codes as much involves a tick box approach. Students should use this question as a research topic and search for relevant academic articles to support their answer.

11 The developments in CSR are amply covered in the text. The main issue is that the conventional FR framework makes no or little allowance for CSR and many businesses view CSR as distinct from FR. In addition CSR as it is currently produced lacks comparability, relevance and reliability. Whether such reporting alleviates social and environmental problems is questionable but it is a chain in the link to ensure that businesses take account of such issues in their business decisions. Students should use this question as a research topic and search for relevant academic articles to support their answer.

12 Again amply covered in the text but to reiterate the principles are:
Integrity, objectivity, professional competence and due care, confidentiality, professional behaviour;
and the threats are:
self-interest, intimidation, self-review and familiarity.
Activities 11.14, 11.15 and 11.16 cover the threats in more detail.

Chapter 12 Basics of Interpretation of Financial Statements

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

ROCE	<i>Alpha plc</i>	<i>Omega plc</i>
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 income 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.

2 A supermarket is a commercial company whose objective it is to buy goods from manufacturers or wholesale companies and to sell it with a profit to the customers who is the end user of the product. A manufacturer is an industrial company, buying materials and components from other industrial companies or wholesalers and transforming these elements into finished or semi-finished products which are sold to either commercial or other industrial companies.

Supermarkets are efficient when they have a high turnover rate of their products. Further in comparison to industrial companies, their customers pay most of the time immediately. Supermarkets have quite some buying power and therefore they can extend the payments to their suppliers. Probably supermarkets will have less resources tied up in inventory, they will have lower amounts under the heading receivables and they might have larger amounts under the heading suppliers than their industrial counterpart. Of course all this should be expressed in relative terms.

3 Question: You are required to comment on the financial position of Olivet Ltd as at 20X5. Calculate any ratios you feel necessary.

Olivet Ltd

Ratios		20X4		20X5
return on capital employed	$20 + 5 = 88.5$	28.2%	$10 + 7.5 = 129.5$	13.5%
GP percentage		50%		40%
NP percentage		20%		10%
sales to capital employed		1.13		0.77
return on owners' equity		52%		18.3%
gearing ratio		56.5%		57.9%
current ratio	$49/30 = 1.6:1$		$57.5/42 = 1.37:1$	
acid test		0.72:1		0.6:1
debtors' turnover period		73 days		91 days
creditors' turnover period		146 days		182.5 days
stock turnover period		201 days		198 days
dividend cover		2		1
interest cover		5		2.3

From the information given in the question we can identify that

- sales have remained static but cost of sales has increased
- expenses other than interest have been slightly reduced
- dividend has remained at 20X4 level even though profits were reduced; in fact in 20X5 all the profits earned have been paid out in dividend
- land appears to have been revalued as the revaluation reserve has increased by £10 000
- further buildings, equipment and investments have been purchased during 20X5
- stock, debtors and creditors have all increased in 20X5

- there is a bank overdraft in 20X5.

The above suggests that Olivet has attempted to expand by purchasing further fixed assets but this does not appear to have produced extra sales. Ratios of all types have worsened: indeed, the ROCE has halved, as has the net profit percentage. The return on owners' equity has fallen sharply and the current dividend policy appears rather imprudent.

It is possible that Olivet increased its investment in fixed assets towards the end of the year and so they will not have generated revenue for a full year. However, even if this is the case the decline in the profit percentages is still a potentially dangerous situation.

4 (a) This company has a number of features which appear unusual at first sight. The most obvious is that there are hardly any debtors. On the other hand the company seems to have over £2m as cash, in hand as well as positive bank balances. The stock turnover period is also short. In one sense this demonstrates a remarkably efficient organization. Stock is sold quickly, sales are paid for very quickly indeed – and creditors appear willing to wait for their money. The effect of this on the statement of financial position is to produce a total of current assets which is very much lower than the current liabilities, which gives the impression of a very illiquid business.

But the positive aspects of this situation surely outweigh the possible negative ones. Much of the company's activities are being financed, presumably interest free, by the creditors! If we take the given figures literally, it appears that the company buys stock, sells it and makes its profit 21 days later, actually receives the sales proceeds 23 days after the purchase, but does not have to pay for its original purchase for another seven days after that. Gearing has risen by 5400%, but this figure is quite meaningless as it was virtually zero in 1991. Gearing is still low, there are enormous fixed assets which are presumably available as security for any further required borrowings, and the company has a large and apparently regular positive flow of funds from its trading operations. In reality the company seems to have cash available on tap whenever it wants it.

From a profitability point of view the position also seems very sound. Profit to sales may not be all that high, but the sales volume is clearly great, and profit to capital is good. It is hard to criticize EPS of 16 pence on a 10 pence nominal value share. It is important to note that the ROCE and ROOE figures given could be misleading if not interpreted carefully. The ROCE is before tax and the ROOE is after tax. Further, the ROOE relates to all shareholders. The enquiry here explicitly relates to an ordinary shareholder. A return on ordinary shareholders' interest should perhaps be calculated. This might be

31

142 = 21.8%

As an overall comment the company, probably in the retail or cash-and-carry sector, seems in a very strong position and there seems no reason to rush out and sell ordinary shares.

(b) (i) This is quite straightforward. The loan redemption fund represents a sum of money which is being put aside, obviously by transfer from the firm's bank account, for the purpose of redeeming the loan related to it. The fund may simply be sitting in some separate bank or investment account, or perhaps invested in some kind of insurance policy.

(ii) An asset can be defined as a resource possessed or controlled by the business which is expected to benefit the business and which has reached the business through some market transaction. Thus something does not have to be in use to be an asset: it merely has to be expected to be useful at some future time. The £49m therefore certainly represents assets. The point relating to these assets not being in use is that the process of depreciation should not yet have begun. Depreciation applies the matching principle in relating expenses to benefits. Since these assets are not yet in use there are not yet any benefits. Therefore there should not yet be any expenses, there will be no depreciation and therefore no effect on the reported profit.

(iii) What is happening with the capitalisation of interest is that a transfer is being made from interest expense account to an asset account, almost certainly to a fixed asset account. This of course has the effect of increasing this year's profit. It also increases the total recorded cost of the fixed asset, and therefore increases the amount which will be depreciated over the life of the asset. Expense is therefore being deferred rather than avoided. The rationale for doing it is the perfectly defensible one that the interest arises from loans taken out to finance the relevant fixed asset and so represents a part of the cost of acquiring that fixed asset. This argument can be criticized however, e.g. on the grounds that the link between loan and fixed asset is at best tenuous, and generally that the treatment lacks prudence.

5(a)

	1991	1990	
Current ratio	30 500	28 500	
	—————	—————	=127 =143
	24 000	20 000	
Quick assets ratio	16 500	15 500	
	—————	—————	=069 =078
	24 000	20 000	
Stock (number of days held)	14 000	13 000	
	—————	—————	x 365 = 122 days x 365 = 140 (lays
Debtors (number of day's outstanding)	16 000	15 000	
	—————	—————	x 365 = 97 days x 365 = 109 days
	60 000	50 000	
Creditors (number of days outstanding)	24 000	20 000	
	—————	—————	x 365 = 209 days x 365 = 215 days
	42 000	34 000	
Gross profit %	18 000	16 000	
	—————	—————	= 30% = 32%
	60 000	50 000	
Net profit %	300	1 700	

(before taxation)	———— = 0.5%	———— = 3.4%
	60 000	50 000
Interest cover	2 500	3 000
	———— = 1.14	———— = 2.31
	2 200	1 300
Dividend cover	–50	1 100
	———— = –0.08	———— = 1.83
	600	600
ROOE (before taxation)	300	1 700
	———— = 2.3%	———— = 12%
	13 000	14 000
ROCE	2 500	3 000
	———— = 13%	———— = 15%
	19 000	19 500
Gearing	6 000	5 500
	———— = 32%	———— = 28%
	19 000	19 500

(b) The general position in 1990 might be characterized as dull. All the turnover ratios are high, especially creditors turnover, although this may partly be a question of the industry involved. Current and quick ratios are probably safe enough provided of course that the going-concern convention can be assumed, i.e. that we can assume the operating cycle will continue in the normal way. Profits and returns are distinctly unexciting, gearing is not excessive.

In 1991 the position has clearly worsened. Turnover ratios are all slightly lower, the net effect being a fall in the current and quick assets ratios. Turnover has increased substantially, at least in money terms, but cost of sales has increased more than in proportion. Perhaps the most significant events relate to gearing and interest. Borrowing has increased somewhat, but interest expense has increased very substantially indeed; the interest cover ratio shows a very shaky position. The other important point to emphasize is that the dividend payment is being fully maintained in spite of the complete absence of available profits from this year's trading.

Chapter 13 Fixed (Non-current) Tangible Assets

1 Please refer to text. Note the emphasis on intended usage, rather than on the physical nature of the particular item.

2 Please refer to text. Note the significance of allocating the cost over the useful life in proportion to the benefit, i.e. the pattern of expected benefit is theoretically crucial. The relevance or otherwise of other ancillary expenses to the depreciation process is also important.

3 It seems to us that the logical answer is yes. There is a practical argument against this, in that it can be said to lead to a lack of comparability for similar assets where one company receives a grant and another company does not. Contrariwise, facts are facts and, if company A has a net cost lower than company B because A