THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF PAKISTAN (ICPAP)
(Suggested Solution)

Stage	**Skills**	Course Code	**S-403**
Examination	**Summer-2012**	Course Name	**Financial and Corporate Reporting**
Time Allowed	**03 Hours**	Maximum Marks	**100**

NOTES:
1) All questions are to be attempted.
2) Answers are expected to the precise, to the point and well written.
3) Neatness and style will be taken into account in marking the papers.

Question No 1:-

Below are the summarised statements of financial position for three companies as at 31 March 2009:

	Pacemaker		Shield		Video Tech	
Assets	Rs million	Rs million	Rs million	Rs million	Rs million	Rs million
Non-current assets						
Property, plant and equipment		520		280		240
Investments		345		40		Nil
		865		320		240
Current assets						
Inventory	142		160		120	
Trade receivables	95		88		50	
Cash and bank	8	245	22	270	10	180
Total assets		1,110		590		420
Equity and liabilities						
Equity shares of Rs1 each		500		145		100
Share premium	100		Nil		Nil	
Retained earnings	130	230	260	260	240	240
		730		405		340
Non – current liabilities						
10% loan notes		180		20		Nil
Current liabilities		200		165		80
Total equity and liabilities		1,110		590		420

Notes:

Pacemaker is a public listed company that acquired the following investments:

i. Investment in Shield

   On 1 April 2007 Pacemaker acquired 116 million shares in Shield for an immediate cash payment of Rs210 million and issued at par one 10% Rs100 loan note for every 200 shares acquired. Shield's retainedearnings at the date of acquisition were Rs120 million.

ii. Investment in Video Tech

   On 1 October 2008 Pacemaker acquired 30 million shares in Video Tech in exchange for 75 million of its ownshares. The stock market value of Pacemaker's shares at the date of this share exchange was Rs1.60 each.Pacemaker has not yet recorded the investment in Video Tech.

iii. Pacemaker's other investments, and those of Shield, are available-for-sale investments which are carried at their fair values as at 31 March 2008. The fair value of these investments at 31 March 2009 is Rs82 million and Rs37 million respectively.

Other relevant information:

iv. Pacemaker's policy is to value non-controlling interests at their fair values. The directors of Pacemaker assessedthe fair value of the non-controlling interest in Shield at the date of acquisition to be Rs65 million.

   There has been no impairment to goodwill or the value of the investment in Video Tech.

v. At the date of acquisition of Shield owned a recently built property that was carried at its (depreciated) construction cost of Rs62 million. The fair value of this property at the date of acquisition was Rs82 million and ithad an estimated remaining life of 20 years.

   For many years Shield has been selling some of its products under the brand name of 'Kyklop'. At the date ofacquisition the directors of Pacemaker valued this brand at Rs25 million with a remaining life of 10 years. Thebrand is not included in Shield's statement of financial position.

The fair value of all other identifiable assets and liabilities of Shield were equal to their carrying values at thedate of its acquisition.

vi. The inventory of Shield at 31 March 2009 includes goods supplied by Pacemaker for Rs56 million (at selling price from Pacemaker). Pacemaker adds a mark-up of 40% on cost when selling goods to Shield. There are nointra-group receivables or payables at 31 March 2009.

vii. Video Tech's profit is subject to seasonal variation. Its profit for the year ended 31 March 2009 was Rs100 million. Rs20 millions of this profit was made from 1 April 2008 to 30 September 2008.

viii. None of the companies have paid any dividends for many years.

Required:

Prepare the consolidated statement of financial position of Pacemaker as at 31 March 2009.

Answer No 1:-

Consolidated statement of financial position of Pacemaker as at 31 March 2009:

	Rs million	Rs million
Non-current assets		
Tangible		
Property, plant and equipment (w (i))		818
Intangible		
Goodwill (w (ii))		23
Brand (25 – 5 (25/10 x 2 years post acq amortization))		20
Investments		
Investment in associate (w (iii))		144
Other available-for-sale investments (82 + 37)		119
		1,124
Current assets		
Inventory (142 + 160 – 16 URP (w (iv)))	286	
Trade receivables (95 + 88)	183	
Cash and bank (8 + 22)	30	499
Total assets		1,623
Equity and liabilities		
Equity attributable to the parent		
Equity shares (500 + 75 (w (iii)))		575
Share premium (100 + 45 (w (iii))	145	

Retained earnings (w (iv))	247	392
		967
Non-controlling interest (w (v))		91
Total equity		1,058
Non-current liabilities		
10% loan notes (180 + 20)		200
Current liabilities (200 + 165)		365
Total equity and liabilities		1,623

Workings (all figures in Rs million)

The investment in Shield represents 80% (116/145) of its equity and is likely to give Pacemaker control thus Shield should beconsolidated as a subsidiary. The investment in Video Tech represents 30% (30/100) of its equity and is normally treated as anassociate that should be equity accounted.

i.

Property, plant and equipment	
Pacemaker	520
Shield	280
Fair value property (82-62)	20
Post – acquisition depreciation (2 year) (20 ×2/20 years)	(2)
	818

ii.

Goodwill in Shield:		
Investment at cost – cash		210
– loan note (116/200 x Rs100)		58
Cost of the controlling interest		268
Fair value of non-controlling interest (from question)		65
Equity shares	145	
Pre-acquisition profit	120	
Fair value adjustments – property (w (i))	20	
– brand	25	
Fair value of net assets at acquisition		(310)
Goodwill		23

iii. Investment in associate:

	Rs million
Investment at cost (75 x Rs1.60)	120
Share of post-acquisition profit (100 – 20) x 30%	24

	144

The purchase consideration by way of a share exchange (75 million shares in Pacemaker for 30 million shares in Video Tech)would be recorded as an increase in share capital of Rs75 million (Rs1 nominal value) and an increase in share premium of Rs45 million (75 million x Rs0.60).

iv.

Consolidated retained earnings:	
Pacemaker's retained earnings	130
Shield's post-acquisition profits (130 x 80% see below)	104
Gain on investments – Pacemaker (see below)	5
Video Tech's post-acquisition profits (w (iii))	24
URP in Inventories (56 x 40/140)	(16)
	247
Shield's retained earnings:	
Post-acquisition (260 – 120)	140
Additional depreciation/Amortisation (2 + 5)	(7)
Loss on available-for-sale investments (40 – 37)	(3)
Adjusted post-acquisition profits	130

Gain on the value of Pacemaker's available-for-sale investments:	
Carrying amount at 31 March 2008 (345 – 210 cash – 58 loan note)	77
Carrying amount at 31 March 2009	82
Gain to retained earnings (or other components of equity)	5

v.

Non-controlling interest	
Fair value on acquisition (from question)	65
Share of adjusted post-acquisition profit (130 x 20% (w (iv)))	26
	91

Question No 2:-

The following trial balance relates to Coca Cola at 30 September 2008:

	Rs'000	Rs'000
Leasehold property – at valuation 1 October 2007 (note (i))	50,000	
Plant and equipment – at cost (note (i))	76,600	
Plant and equipment – accumulated depreciation at 1 October		24,600

2007		
Capitalised development expenditure – at 1 October 2007 (note (ii))	20,000	
Development expenditure – accumulated amortization at 1 October 2007		6,000
Closing inventory at 30 September 2008	20,000	
Trade receivables	43,100	
Bank		1,300
Trade payables and provisions (note (iii))		23,800
Revenue (note (i))		300,000
Cost of sales	204,000	
Distribution costs	14,500	
Administrative expenses (note (iii))	22,200	
Preference dividend paid	800	
Interest on bank borrowings	200	
Equity dividend paid	6,000	
Research and development costs (note (ii))	8,600	
Equity shares of 25 Paisa each		50,000
8% redeemable preference shares of Rs1 each (note (iv))		20,000
Retained earnings at 1 October 2007		24,500
Deferred tax (note (v))		5,800
Leasehold property revaluation reserve		10,000
	466,000	466,000

The following notes are relevant:

i. **Non-current assets – tangible:**

The leasehold property had a remaining life of 20 years at 1 October 2007. The company's policy is to revalueits property at each year end and at 30 September 2008 it was valued at Rs43 million. Ignore deferred tax onthe revaluation.

On 1 October 2007 an item of plant was disposed of for Rs2.5 million cash. The proceeds have been treated assales revenue by Coca Cola. The plant is still included in the above trial balance figures at its cost of Rs8 million andaccumulated depreciation of Rs4 million (to the date of disposal).

All plant is depreciated at 20% per annum using the reducing balance method.

Depreciation and amortization of all non-current assets is charged to cost of sales.

ii. **Non-current assets – intangible:**

In addition to the capitalised development expenditure (of Rs20 million), further research and development costswere incurred on a new project which commenced on 1 October 2007. The research stage of the new projectlasted until

31 December 2007 and incurred Rs1.4 million of costs. From that date the project incurreddevelopment costs of Rs800, 000 per month. On 1 April 2008 the directors became confident that the projectwould be successful and yield a profit well in excess of its costs. The project is still in development at30 September 2008.

Capitalised development expenditure is amortised at 20% per annum using the straight-line method. Allexpensed research and development is charged to cost of sales.

iii. Coca Cola is being sued by a customer for Rs2 million for breach of contract over a cancelled order. Coca Cola has obtained legal opinion that there is a 20% chance that Coca Cola will lose the case. Accordingly Coca Cola has provided Rs400, 000 (Rs2 million x 20%) included in administrative expenses in respect of the claim. The unrecoverable legal costs of defending the action are estimated at Rs100, 000. These have not been provided for as the legal action will not go to court until next year.

iv. The preference shares were issued on 1 April 2008 at par. They are redeemable at a large premium which gives them an effective finance cost of 12% per annum.

v. The directors have estimated the provision for income tax for the year ended 30 September 2008 at Rs11.4 million. The required deferred tax provision at 30 September 2008 is Rs6 million.

Required:

a) Prepare the statement of comprehensive income for the year ended 30 September 2008.

b) Prepare the statement of changes in equity for the year ended 30 September 2008.

c) Prepare the statement of financial position as at 30 September 2008.

Note: notes to the financial statements are not required.

Answer No 2:-

a) Coca Cola – Statement of comprehensive income for the year ended 30 September 2008

	Rs'000
Revenue (300,000 – 2,500)	297,500
Cost of sales (w (i))	(225,400)
Gross profit	72,100
Distribution costs	(14,500)
Administrative expenses (22,200 – 400 + 100 see note below)	(21,900)
Finance costs (200 + 1,200 (w (ii)))	(1,400)
Profit before tax	34,300
(Income tax expense (11,400 + (6,000 – 5,800 deferred tax))	(11,600)

	Rs'000
Profit for the year	22,700
Other comprehensive income	
Loss on leasehold property revaluation (w (iii))	(4,500)
Total comprehensive income for the year	18,200

Note: as it is considered that the outcome of the legal action against Coca Cola is unlikely to succeed (only a 20% chance) it isinappropriate to provide for any damages. The potential damages are an example of a contingent liability which should bedisclosed (at Rs2 million) as a note to the financial statements. The unrecoverable legal costs are a liability (the start of thelegal action is a past event) and should be provided for in full.

b) Coca Cola – Statement of changes in equity for the year ended 30 September 2008

	Equity shares Rs'000	Revaluation reserve Rs'000	Retained earnings Rs'000	Total equity Rs'000
Balances at 1 October 2007	50,000	10,000	24,500	84,500
Dividend			(6,000)	(6,000)
Comprehensive income		(4,500)	22,700	18,200
Balances at 30 September 2008	50,000	5,500	41,200	96,700

c) Coca Cola – Statement of financial position as at 30 September 2008

Assets	Rs'000	Rs'000
Non-current assets (w (iii))		
Property, plant and equipment (43,000 + 38,400)		81,400
Development costs		14,800
		96,200
Current assets		
Inventory	20,000	
Trade receivables	43,100	63,100
Total assets		159,300
Equity and liabilities:		
Equity (from (b))		
Equity shares of 25 Paisa each		50,000
Revaluation reserve	5,500	
Retained earnings	41,200	46,700
		96,700
Non-current liabilities		
Deferred tax	6,000	
8% redeemable preference shares (20,000 + 400 (w (ii)))	20,400	26,400
Current liabilities		
Trade payables (23,800 – 400 + 100 – re legal action)	23,500	
Bank overdraft	1,300	
Current tax payable	11,400	36,200
Total equity and liabilities		159,300

Workings (figures in brackets in Rs'000)

i.

Cost of sales:	Rs'000
Per trial balance	204,000
Depreciation (w (iii)) – leasehold property	2,500
– plant and equipment	9,600
Loss on disposal of plant (4,000 – 2,500)	1,500
Amortisation of development costs (w (iii))	4,000
Research and development expensed (1,400 + 2,400 (w (iii)))	3,800
	225,400

ii. The finance cost of Rs1.2 million for the preference shares is based on the effective rate of 12% applied to Rs20 million issue proceeds of the shares for the six months they have been in issue (20m x 12% x 6/12). The dividend paid of Rs800, 000 is based on the nominal rate of 8%. The additional Rs400, 000 (accrual) is added to the carrying amount of the preference shares in the statement of financial position. As these shares are redeemable they are treated as debt andtheir dividend is treated as a finance cost.

iii. Non-current assets:

Leasehold property	
Valuation at 1 October 2007	50,000
Depreciation for year (20 year life)	(2,500)
Carrying amount at date of revaluation	47,500
Valuation at 30 September 2008	(43,000)
Revaluation deficit	4,500
	Rs'000
Plant and equipment per trial balance (76,600 – 24,600)	52,000
Disposal (8,000 – 4,000)	(4,000)
	48,000
Depreciation for year (20%)	(9,600)
Carrying amount at 30 September 2008	38,400
Capitalised/deferred development costs	
Carrying amount at 1 October 2007 (20,000 – 6,000)	14,000
Amortised for year (20,000 x 20%)	(4,000)
Capitalised during year (800 x 6 months)	4,800
Carrying amount at 30 September 2008	14,800

Note: development costs can only be treated as an asset from the point where they meet the recognition criteria inIAS 38 Intangible assets. Thus development costs from 1 April to 30 September 2008 of Rs4.8 million (800 x 6 months)can be capitalised. These will not be amortised as the project is still in development. The research costs of Rs1.4 millionplus

three months' development costs of Rs2.4 million (800 x 3 months) (i.e. those incurred before 1 April 2008) aretreated as an expense.

Question No 3:-

The dividend paid in November 2010 was Rs5.6 million. This is based on 112 million shares in issue (56,000 x 2 – the shares are 50 Paisa each) times 5 Paisa.

Income statements for the year ended 31 March

	2011	2010
	Rs'000	Rs'000
Revenue	25,500	17,250
Cost of sales	(14,800)	(10,350)
Gross profit	10,700	6,900
Distribution costs	(2,700)	(1,850)
Administrative expenses	(2,100)	(1,450)
Finance costs	(650)	(100)
Profit before taxation	5,250	3,500
Income tax expense	(2,250)	(1,000)
Profit for the year	3,000	2,500

Statements of financial position as at 31 March

	2011		2010	
	Rs'000	Rs'000	Rs'000	Rs'000
Non-current assets				
Property, plant and equipment		9,500		5,400
Intangibles		6,200		Nil
		15,700		5,400
Current assets				
Inventory	3,600		1,800	
Trade receivables	2,400		1,400	
Bank	Nil		4,000	
Non-current assets held for sale	2,000	8,000	Nil	7,200
Total assets		23,700		12,600

Equity and liabilities				
Equity				
Equity shares of Rs1 each		5,000		5,000
Retained earnings		4,500		2,250
		9,500		7,250
Non-current liabilities				
5% loan notes		2,000		2,000
8% loan notes		7,000		Nil
Current liabilities				
Bank overdraft	200		Nil	
Trade payables	2,800		2,150	
Current tax payable	2,200	5,200	1,200	3,350
Total equity and liabilities		23,700		12,600

Notes

i. There were no disposals of non-current assets during the period; however Bengal does have some non-current assets classified as 'held for sale' at 31 March 2011.
ii. Depreciation of property, plant and equipment for the year ended 31 March 2011 was Rs640, 000.

A disappointed shareholder has observed that although revenue during the year has increased by 48% (8,250/17,250 x 100), profit for the year has only increased by 20% (500/2,500 x 100).

Required:

a) **Prepare a statement of cash flows for Bengal for the year ended 31 March 2011, in accordance with IAS 7 Statement of cash flows, using the indirect method.**
b) **Using the information in the question and your answer to (a) above, comment on the performance (including addressing the shareholder's observation) and financial position of Bengal for the year ended 31 March 2011.**

Answer No 3:-

a) Bengal – Statement of cash flows for the year ended 31 March 2011:
(Note: figures in brackets are in Rs'000)

	Rs'000	**Rs'000**
Cash flows from operating activities:		

Profit before tax		5,250
Adjustments for:		
depreciation of non-current assets		640
finance costs		650
Increase in inventories (3,600 – 1,800)		(1,800)
Increase in receivables (2,400 – 1,400)		(1,000)
Increase in payables (2,800 – 2,150)		650
Cash generated from operations		4,390
Finance costs paid		(650)
Income tax paid (w (i))		(1,250)
Net cash from operating activities		2,490
Cash flows from investing activities:		
Purchase of property, plant and equipment (w (ii))	(6,740)	
Purchase of intangibles	(6,200)	
Net cash used in investing activities		(12,940)
Cash flows from financing activities:		
Issue of 8% loan note	7,000	
Equity dividends paid (w (iii))	(750)	
Net cash from financing activities		6,250
Net decrease in cash and cash equivalents		(4,200)
Cash and cash equivalents at beginning of period		4,000
Cash and cash equivalents at end of period		(200)

Workings

i.

Income tax paid:	**Rs'000**
Provision b/f	(1,200)
Income statement tax charge	(2,250)
Provision c/f – current	2,200
Balance – cash paid	(1,250)

ii.

Property, plant and equipment:	**Rs'000**
Balance b/f	5,400
Depreciation	(640)
Balance c/f – current	(9,500)
– held for sale	(2,000)
Balance – cash purchases	6,740

iii.

Equity dividend

Retained earnings b/f	2,250
Profit for period	3,000
Retained earnings c/f	(4,500)
Balance – dividend paid	750

b) **Note: references to 2011 and 2010 refer to the periods ending 31 March 2011 and 2010 respectively.**

It is understandable that the shareholder's observations would cause concern. A large increase in sales revenue has not ledto a proportionate increase in profit. To assess why this has happened requires consideration of several factors that couldpotentially explain the results. Perhaps the most obvious would be that the company has increased its sales by discountingprices (cutting profit margins).Interpreting the ratios in the appendix rules out this possible explanation as the gross profitmargin has in fact increased in 2011 (up from 40% to 42%). Another potential cause of the disappointing profit could beoverheads (distribution costs and administrative expenses) getting out of control, perhaps due to higher advertising costs ormore generous incentives to sales staff. Again, when these expenses are expressed as a percentage of sales, this does notexplain the disparity in profit as the ratio has remained at approximately 19%. What is evident is that there has been a verylarge increase in finance costs which is illustrated by the interest cover deteriorating from 36 times to only 9 times. The other'culprit' is the taxation expense: expressed as a percentage of pre-tax accounting profit, the effective rate of tax has gone from28.6% in 2010 to 42.9% in 2011. There are a number of factors that can affect a period's effective tax rate (including underorover-provisions from the previous year), but judging from the figures involved, it would seem likely that either there was amaterial adjustment from an under-provision of tax in 2010 or there has been a considerable increase in the rate levied bythe taxation authority.

As an illustration of the effect, if the same effective tax rate in 2010 had applied in 2011, the after-tax profit would have been Rs3, 749,000 (5,250 x (100% – 28.6%) rounded) and, using this figure, the percentage increase in profit would be 50%

((3,749 – 2,500)/2,500 x 100) which is slightly higher than the percentage increase in revenue. Thus an increase in thetax rate and increases in

finance costs due to much higher borrowings more than account for the disappointing profitcommented upon by the concerned shareholder.
The other significant observation in comparing 2011 with 2010 is that the company has almost certainty acquired anotherbusiness. The increased expenditure on property, plant and equipment of Rs6, 740,000 and the newly acquired intangibles(probably goodwill) of Rs6.2 million are not likely to be attributable to organic or internal growth. Indeed the decrease in thebank balance of Rs4.2 million and the issue of Rs7 million loan notes closely match the increase in non-current assets. Thisimplies that the acquisition has been financed by cash resources (which the company looks to have been building up) andissuing debt (no equity was issued). This in turn explains the dramatic increase in the gearing ratio (and the consequent fallin interest cover) and the fall in the current ratio (due to the use of cash resources for the business purchase). Although thecurrent ratio at 1.5:1 is on the low side of acceptability, it does include Rs2 million of non-current assets held for sale. A bettercomparison with 2010 is the current ratio at 1.2:1 which excludes the non-current assets held for sale. It may be that theseassets were part of the acquisition of the new business and are 'surplus to requirements', hence they have been madeavailable for sale. They are likely to be valued at their 'fair value less cost to sell' and the prospect of their sale should behighly probable (normally within one year). That said, if the assets are not sold in the near future, it would call into questionthe acceptability of the company's current ratio which may cause short-term liquidity problems.
The overall performance of Bengal has deteriorated (as measured by its ROCE) from 38.9% to 31.9%. This is mainly due toa lower rate of net asset turnover (down from 1.9 to 1.4 times), however when the turnover of property, plant and equipmentis considered (down from 3.2 to 2.7 times) the asset utilization position is not as bad as it first looks, in effect it is thepresence of the acquired intangibles that is mostly responsible for the fall.
Further, it may be that the new business was acquired part way through the year and thus the returns from this element maybe greater next year when a full period's profits will be reported. It may also be that the integration of the new businessrequires time (and expense) before it delivers its full potential.

In summary, although reported performance has deteriorated, it may be that future results will benefit from the current year'sinvestment and show considerable improvement. Perhaps some equity should have been issued to lower the company'sgearing (and finance costs) and if the dividend of Rs750, 000 had been suspended for a year there would be a better liquidposition.

Question No 4:-

The International Accounting Standards Board (IASB) has begun a joint project to revisit its conceptual framework for financial accounting and reporting. The goals of the project are to build on the existing frameworks and converge them into a common framework.

Required:

a) **Discuss why there is a need to develop an agreed international conceptual framework and the extent to which an agreed international conceptual framework can be used to resolve practical accounting issues.**
b) **Discuss the key issues which will need to be addressed in determining the basic components of an internationally agreed conceptual framework.**

Appropriateness and quality of discussion.

Answer No 4:-

a) The IASB wish their standards to be 'principles-based' and in order for this to be the case, the standards must be based on fundamental concepts. These concepts need to constitute a framework which is sound, comprehensive and internally consistent. Without agreement on a framework, standard setting is based upon the personal conceptual frameworks of the individual standard setters which may change as the membership of the body changes and results in standards that are not consistent with each other. Such a framework is designed not only to

assist standard setters, but also preparers of financial statements, auditors and users.

A common goal of the IASB is to converge their standards with national standard setters. The IASB will encounter difficultiesconverging their standards if decisions are based on different frameworks. The IASB has been pursuing a number of projectsthat are aimed at achieving short term convergence on certain issues with national standard setters as well as major projectswith them. Convergence will be difficult if there is no consistency in the underlying framework being used.

Frameworks differ in their authoritative status. The IASB's Framework requires management to expressly consider theFramework if no standard or interpretation specifically applies or deals with a similar and related issue. However, certainframeworks have a lower standing. For example, entities are not required to consider the concepts embodied in certainnational frameworks in preparing financial statements. Thus the development of an agreed framework would eliminatedifferences in the authoritative standing of conceptual frameworks and lead to greater consistency in financial statementsinternationally.

The existing concepts within most frameworks are quite similar. However, these concepts need revising to reflect changes inmarkets, business practices and the economic environment since the concepts were developed. The existing frameworks needdeveloping to reflect these changes and to fill gaps in the frameworks. For example, the IASB's Framework does not containa definition of the reporting entity. An agreed international framework could deal with this problem, especially if priority wasgiven to the issues likely to give short-term standard setting benefits.

Many standard setting bodies attempted initially to resolve accounting and reporting problems by developing accountingstandards without an accepted theoretical frame of reference. The result has been inconsistency in the development ofstandards both nationally and internationally. The frameworks were developed when several of their current standards werein existence. In the absence of an agreed conceptual framework the same theoretical issues are revisited on several occasionsby standard setters. The result is inconsistencies and incompatible concepts. Examples of this are substance over form andmatching versus prudence. Some standard setters such as the IASB permit two methods of accounting for

the same set ofcircumstances. An example is the accounting for joint ventures where the equity method and proportionate consolidation areallowed.
Additionally there have been differences in the way that standard setters have practically used the principles in the framework.Some national standard setters have produced a large number of highly detailed accounting rules with less emphasis ongeneral principles. A robust framework might reduce the need for detailed rules although some companies operate in adifferent legal and statutory context than other entities. It is important that a framework must result in standards that accountappropriately for actual business practice.
An agreed framework will not solve all accounting issues, nor will it obviate the need for judgement to be exercised in resolvingaccounting issues. It can provide a framework within which those judgements can be made.
A framework provides standard setters with both a foundation for setting standards, and concepts to use as tools for resolvingaccounting and reporting issues. A framework provides a basic reasoning on which to consider the merits of alternatives. Itdoes not provide all the answers, but narrows the range of alternatives to be considered by eliminating some that areinconsistent with it. It, thereby, contributes to greater efficiency in the standard setting process by avoiding the necessity ofhaving to redebate fundamental issues and facilitates any debate about specific technical issues. A framework should alsoreduce political pressures in making accounting judgements. The use of a framework reduces the influence of personal biasesin accounting decisions.
However, concepts statements are by their nature very general and theoretical in their wording, which leads to alternativeconclusions being drawn. Whilst individual standards should be consistent with the Framework, in the absence of a specificstandard, it does not follow that concepts will provide practical solutions. IAS8 ‘Accounting Policies, Changes in AccountingEstimates and Errors’ sets out a hierarchy of authoritative guidance that should be considered in the absence of a standard.In this case, management can use its judgement in developing and applying an accounting policy, albeit by considering theIASB framework, but can also use accounting standards issued by other bodies.

Thus an international framework may nottotally provide solutions to practical accounting problems.

b) There are several issues which have to be addressed if an international conceptual framework is to be successfully developed.

These are:

i. **Objectives**

Agreement will be required as to whether financial statements are to be produced for shareholders or a wide range ofusers and whether decision usefulness is the key criteria or stewardship. Additionally there is the question of whetherthe objective is to provide information in making credit and investment decisions.

ii. **Qualitative Characteristics**

The qualities to be sought in making decisions about financial reporting need to be determined. The decision usefulnessof financial reports is determined by these characteristics. There are issues concerning the trade-offs between relevanceand reliability. An example of this concerns the use of fair values and historical costs. It has been argued that historicalcosts are more reliable although not as relevant as fair values. Additionally there is a conflict between neutrality and thetraditions of prudence or conservatism. These characteristics are constrained by materiality and benefits that justifycosts.

iii. **Definitions of the elements of financial statements**

The principles behind the definition of the elements need agreement. There are issues concerning whether 'control'should be included in the definition of an asset or become part of the recognition criteria. Also the definition of 'control'is an issue particularly with financial instruments. For example, does the holder of a call option 'control' the underlyingasset? Some of the IASB's standards contravene its own conceptual framework. IFRS3 requires the capitalisation ofgoodwill as an asset despite the fact that it can be argued that goodwill does not meet the definition of an asset in theFramework. IAS12 requires the recognition of deferred tax liabilities that do not meet the liability definition. Similarlyequity and liabilities need to be capable of being clearly distinguished. Certain financial instruments could either beliabilities or equity. For example obligations settled in shares.

iv. **Recognition and De-recognition**

The principles of recognition and de-recognition of assets and liabilities need reviewing. Most frameworks haverecognition criteria, but there are issues over the timing of recognition. For example, should an asset be recognised whena value can be placed on it or when a cost has been incurred? If an asset or liability does not meet recognition criteriawhen acquired or incurred, what subsequent event causes the asset or liability to be recognised? Most frameworks donot discuss de-recognition. (The IASB's Framework does not discuss the issue.) It can be argued that an item should bede-recognised when it does not meet the recognition criteria, but financial instruments standards (IAS39) require otherfactors to occur before financial assets can be de-recognised. Different attributes should be considered such as legalownership, control, risks or rewards.

v. **Measurement**

More detailed discussion of the use of measurement concepts, such as historical cost, fair value, current cost, etc arerequired and also more guidance on measurement techniques. Measurement concepts should address initialmeasurement and subsequent measurement in the form of revaluations, impairment and depreciation which in turngives rise to issues about classification of gains or losses in income or in equity.

vi. **Reporting entity**

Issues have arisen over what sorts of entities should issue financial statements, and which entities should be includedin consolidated financial statements. A question arises as to whether the legal entity or the economic unit should be thereporting unit. Complex business arrangements raise issues over what entities should be consolidated and the basisupon which entities are consolidated. For example, should the basis of consolidation be 'control' and what does 'control'mean?

vii. **Presentation and disclosure**

Financial reporting should provide information that enables users to assess the amounts, timing and uncertainty of theentity's future cash flows, its assets, liabilities and equity. It should provide management explanations and the limitationsof the information in the reports. Discussions as to the boundaries of presentation and disclosure are required.

Question No 5:-

Whilst acknowledging the importance of high quality corporate reporting, the recommendations to improve it aresometimes questioned on the basis that the marketplace for capital can determine the nature and quality of corporatereporting. It could be argued that additional accounting and disclosure standards would only distort a marketmechanism that already works well and would add costs to the reporting mechanism, with no apparent benefit. Itcould be said that accounting standards create costly, inefficient, and unnecessary regulation. It could be argued thatincreased disclosure reduces risks and offers a degree of protection to users. However, increased disclosure has severalcosts to the preparer of financial statements.

Required:

a) **Explain why accounting standards are needed to help the market mechanism work effectively for the benefit of preparers and users of corporate reports.**
b) **Discuss the relative costs to the preparer and benefits to the users of financial statements of increased disclosure of information in financial statements.**

Quality of discussion and reasoning.

Answer No 5:-

a) It could be argued that the marketplace already offers powerful incentives for high-quality reporting as it rewards such by easing or restricting access to capital or raising or lowering the cost of borrowing capital depending on the quality of the entity's reports. However, accounting standards play an important role in helping the market mechanism work effectively. Accounting standards are needed because they:

- Promote a common understanding of the nature of corporate performance and this facilitates any negotiations between users and companies about the content of financial statements. For example, many loan agreements specify that a company provide the lender with financial statements prepared in accordance with generally accepted accounting principles or International Financial Reporting Standards. Both the company and the lender understand the terms and are

comfortable that statements prepared according to those standards will meet certain information needs. Without standards, the statements would be less useful to the lender, and the company and the lender would have to agree tocreate some form of acceptable standards which would be inefficient and less effective.

- Assist neutral and unbiased reporting. Companies may wish to portray their past performance and future prospects in the most favourable light. Users are aware of this potential bias and are sceptical about the information they receive.Standards build credibility and confidence in the capital marketplace to the benefit of both users and companies.
- Improve the comparability of information across companies and national boundaries. Without standards, there would be little basis to compare one company with others across national boundaries which is a key feature of relevantinformation.
- Create credibility in financial statements. Auditors verify that information is reported in accordance with standards andthis creates public confidence in financial statements
- Facilitate consistency of information by producing data in accordance with an agreed conceptual framework. A consistent approach to the development and presentation of information assists users in accessing information in an efficientmanner and facilitates decision-making.

b) Increased information disclosure benefits users by reducing the likelihood that they will misallocate their capital. This is obviously a direct benefit to individual users of corporate reports. The disclosure reduces the risk of misallocation of capitalby enabling users to improve their assessments of a company's prospects. This creates three important results.

i. Users use information disclosed to increase their investment returns and by definition support the most profitable companies which are likely to be those that contribute most to economic growth. Thus, an important benefit of information disclosure is that it improves the effectiveness of the investment process.

ii. The second result lies in the effect on the liquidity of the capital markets. A more liquid market assists the effective allocation of capital by allowing users to reallocate their capital quickly. The degree of information asymmetry between the buyer and seller and

the degree of uncertainty of the buyer and the seller will affect the liquidity of the market as lower asymmetry and less uncertainty will increase the number of transactions and make the market more liquid.

Disclosure will affect uncertainty and information asymmetry.

iii. Information disclosure helps users understand the risk of a prospective investment. Without any information, the user has no way of assessing a company's prospects. Information disclosure helps investors predict a company's prospects. Getting a better understanding of the true risk could lower the price of capital for the company. It is difficult to prove however that the average cost of capital is lowered by information disclosure, even though it is logically and practically impossible to assess a company's risk without relevant information. Lower capital costs promote investment, which canstimulate productivity and economic growth.

However although increased information can benefit users, there are problems of understandability and information overload.

Information disclosure provides a degree of protection to users. The benefit is fairness to users and is part of corporateaccountability to society as a whole.

The main costs to the preparer of financial statements are as follows:

i. the cost of developing and disseminating information,
ii. the cost of possible litigation attributable to information disclosure,
iii. the cost of competitive disadvantage attributable to disclosure.

The costs of developing and disseminating the information include those of gathering, creating and auditing the information.

Additional costs to the preparers include training costs, changes to systems (for example on moving to IFRS), and the morecomplex and the greater the information provided, the more it will cost the company.

Although litigation costs are known to arise from information disclosure, it does not follow that all information disclosure leadsto litigation costs. Cases can arise from insufficient disclosure and misleading disclosure.

Only the latter is normally promptedby the presentation of information disclosure. Fuller disclosure could lead to lower costs of litigation as the stock market wouldhave more realistic expectations of the company's prospects and the discrepancy between the valuation implicit in the marketprice and the valuation based on a company's financial statements would be lower. However, litigation costs do notnecessarily increase with the extent of the disclosure. Increased disclosure could reduce litigation costs.

Disclosure could weaken a company's ability to generate future cash flows by aiding its competitors. The effect of disclosureon competitiveness involves benefits as well as costs. Competitive disadvantage could be created if disclosure is made relatingto strategies, plans, (for example, planned product development, new market targeting) or information about operations (forexample, production-cost figures). There is a significant difference between the purpose of disclosure to users andcompetitors. The purpose of disclosure to users is to help them to estimate the amount, timing, and certainty of future cashflows. Competitors are not trying to predict a company's future cash flows, and information of use in that context is notnecessarily of use in obtaining competitive advantage. Overlap between information designed to meet users' needs andinformation designed to further the purposes of a competitor is often coincidental. Every company that could suffer competitivedisadvantage from disclosure could gain competitive advantage from comparable disclosure by competitors. Published figuresare often aggregated with little use to competitors.

Companies bargain with suppliers and with customers, and information disclosure could give those parties an advantage innegotiations. In such cases, the advantage would be a cost for the disclosing entity. However, the cost would be offsetwhenever information disclosure was presented by both parties, each would receive an advantage and a disadvantage.

There are other criteria to consider such as whether the information to be disclosed is about the company. This is both abenefit and a cost criterion. Users of corporate reports need company-specific data, and it is typically more costly to obtainand present information about matters external to the company. Additionally, consideration must be given as to whether thecompany is the best source for the information. It could be inefficient

for a company to obtain or develop data that other, moreexpert parties could develop and present or do develop at present.

There are many benefits to information disclosure and users have unmet information needs. It cannot be known with anycertainty what the optimal disclosure level is for companies. Some companies through voluntary disclosure may haveachieved their optimal level. There are no quantitative measures of how levels of disclosure stand with respect to optimallevels. Standard setters have to make such estimates as best they can, guide by prudence, and by what evidence of benefitsand costs they can obtain.