ADVANCED FINANCIAL ACCOUNTING

Second Edition

SOLUTIONS MANUAL

Richard Lewis
David Pendrill

Advanced Financial Accounting – Solutions Manual

Preface

This solutions manual contains our suggested solutions to the 85 questions taken from the professional examinations of the Institute of Chartered Accountants in England and Wales (ICAEW) and Chartered Association of Certified Accountants (CACA) which we have included in the second edition of Advanced Financial Accounting.

We have attempted to prepare solutions which would have earned a candidate a very good pass. However both teachers and students using this manual should recognize that, at this level, there may be more than one acceptable solution to a question, particular to essay questions on controversial subjects.

As those studying for the professional examinations of the ICAEW will know, that body has decided not to assist its students by preparing suggested solutions. However all but a handful of our solutions to the ICAEW questions have previously appeared in many editions of the Wooller's Guides to professional examinations and, for that purpose, have been assessed by the relevant examiners as being adequate to ensure a comfortable pass. We are extremely grateful to Dr Jeff Wooller for his kind permission to reprint solutions from his extremely useful publications.

Unlike the ICAEW, the CACA does help its students by publishing suggested solutions to its examination papers and we have consulted these solutions when preparing our answers. As might be expected at this level of study, we frequently disagree with the solutions which have been published by CACA and would often criticize these solutions for failing to answer the specific questions set. We have therefore attempted to provide better solutions which do answer the specific questions set, while bringing in the major points which the examiner appeared to be looking for.

We are particularly concerned about the suitability of some of the questions included in the CACA Level 3 paper 'Advanced Financial Accounting' . Recent papers have included numerical questions of such length and complexity that they were impossible to answer adequately in the time available. Examples of such questions are 6.6, 10.5, 12.6 and 14.3 and students attempting these questions should treat the time limits, as indicated by the marks allocated, with a large pinch of salt. They should use them as long exercises to help develop their understanding of the particular topic. Fortunately there are signs, in the June 1985 paper, that the CACA has taken action to curb this over-demanding approach and we are hopeful that future questions will be capable of being attempted in the time allocated.

RWL
DP

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Contents

1 Introduction

QUESTION 1.1

The key phrases will be analysed below. For the sake of brevity, the term 'accountant' will be used to describe the person or group responsible for the preparation of the Corporate Financial Report.

(a) Communicate

It is suggested that it is not sufficient for the accountant merely to present the information; he should also strive to ensure that it is presented in such a way that the user can understand it. However, not all potential users would find the same degree of detail useful, e.g. the employee might find the degree of detail required by the tax authorities or investment analysts overwhelming, while the latter groups would probably find the type of report which was suitable for employees, lacking in significant details.

The need to communicate therefore not only places a professional responsibility on the accountant to produce reports which are understandable, but also poses questions both to accountants and those charged with the regulation of accounting matters as to the desirability of producing different (in terms of detail and complexity) accounting reports for different groups.

(b) Economic measurements of and information about the resources and performance

Traditional accounting practice is based on reports which concentrate on the financial consequences of transactions of which the reporting entity is a party. In other words the accountant deals with transactions which either have or will involve a measurable cash inflow to, or outflow from, the reporting entity. Use of the phrase 'economic measurements and information' suggests that a broader view could be taken of the scope of the information that is included in the corporate financial report. The additional information could cover such areas as the markets in which the company operates, the state of industrial relations, and the environmental consequences of the company's production methods.

One of the main proposals of conventional financial accounting was said to be stewardship, although a very narrow definition of stewardship was employed. Thus, historical cost accounts showed the resources that had been entrusted to the manager of the company and how they had been used but not *how well* they had been used.

Stewardship thus concentrated on the honesty of managers and not on their success as entrepreneurs. This extract from the quotation indicates that financial corporate reports should help users form a judgement about the financial success of a company and hence implies the adoption of new accounting conventions to replace, or complement, those based on historical cost.

(c) <u>Useful to those having reasonable rights to such information</u>

The main point here is the need to decide who has 'reasonable rights' to receive corporate financial information. In general, the view in the past was that the only groups which had a legitimate right to receive information were owners and creditors. Other groups, such as employees, could be given information on a voluntary basis but only in circumstances where to do so would serve the interests of the reporting entity.

An alternative view which is based on a broader social perspective of the obligations of corporate enterprises is that such organizations should be publicly accountable. It is argued that large corporate enterprises control human or material resources on such a scale that the results of their activities have a significant effect on the community as a whole. Acceptance of this point leads to the view (which was adopted by the authors of the Corporate Report) that groups other than owners and creditors are entitled to receive information about the activities of large commercial organizations. These groups include those directly associated with the enterprise (e.g. employees) as well as the government as representatives of the broader community.

QUESTION 1.2

(a) The following groups were considered to be potential users of financial reports.

(i) The *equity investor group* including existing and potential shareholders and holders of convertible securities, etc.

(ii) The *loan creditor group* including existing and potential holders of debentures and loan stock, and providers of short-term secured and unsecured loans and finance.

(iii) The *employee group* including existing, potential and past employees.

(iv) The *analyst-adviser* group including financial analysts, journalists and providers of advisory services.

(v) The *business contact* group including customers, suppliers and competitors.

(vi) The *government* including tax authorities.

(vii) The *public* including special interest groups and political parties.

(b) The information needs of the above groups may be summarized as follows:

(i) Equity Investor Group

Information is required to help make trading decisions regarding securities including decisions on the taking up of rights issues and the acceptance of takeover proposals. Existing shareholders may also need information relevant to resolutions on which they will be asked to vote, including the election of directors.

(ii) Loan creditors

These will need to decide whether a loan should be advanced and, if so, on what terms. Once a loan is made, the creditors will want to monitor the progress of the company to allow them to involve any provisions of the loan agreement which might appear appropriate or take such other action, for example, providing against doubtful debts as may be required.

(iii) Employees

This group will need information to assist them in wage and other negotiations, e.g. on redundancies and conditions of service.

(iv) Analyst-advisers

Their information needs are the same as the group which they are advising, for example the equity investors or employees. However, it is presumed that the group could deal with more sophisticated and detailed information than the members of the groups whom they are advising.

(v) Business contacts

The information needs of customers and suppliers cover the question of whether to trade with the company. Customers will be particularly interested in the prospect of continuity of supply while suppliers will be concerned both with the prospect of future orders and the risk associated with the granting of credit. Competitors and business rivals will be interested in information both as potential investors (or takeover bidders) and to promote their own efficiency by making economic comparisons.

(vi) The government

As the representatives of the public (see below), the government requires information in order to levy taxes and to assess the effects of its economic policies.

(vii) The public

The public has a right to receive information about the impact on the community of the operations of organizations which control substantial resources.

Summary

Whilst there are differences in the needs of the various groups, many of the groups are interested in both past and future profitability and in the related question of the future survival of the entity.

(c) Financial accounts are of no value unless they provide information which helps the users to make decisions. Thus, it might be expected that a consideration of user needs has a significant influence on financial accounting. It therefore follows that those responsible for the regulation of accounting practice should first identify the various users of accounts and assess their needs for information. (This procedure was followed in the discussion document, issued by the ASC, 'The Corporate Report').

The needs of users as determined by the above procedure should be the main factor influencing the development of regulations on financial reporting. This is not to suggest, however, that the accountant should not attempt to educate the user groups if he/she believes that the models used for decision making could be improved.

Whilst the needs of users are an important influence, accounting legislators must also consider the cost of producing information as well as the conflicting needs of the different interest groups.

QUESTION 1.3

(a) In the view of the authors of the 'Corporate Report' the characteristics of useful corporate reports are as follows:

(i) Relevance. This is the characteristic which embodies the fundamental notion that corporate reports should attempt to satisfy, as far as is possible, users' information needs.

(ii) Understandability. This does not mean that accounts should be simple, but that there must be a balance between the need to ensure that all material matters are disclosed and the need to avoid confusing users with too much detail.

(iii) Reliability. Information should be reliable in that users should be able to assess what degree of confidence can be placed on it. Whilst it is desirable that the information should be verified by independent parties it may nonetheless be of value for the entity to supply information which may not be amenable to independent verification.

(iv) Completeness. The information should, so far as is possible, provide users with a rounded picture of the economic activities of the reporting entity.

(v) Objectivity. The information should be free from bias and neutral (not favouring the needs of any particular user group.)

(vi) Timeliness. Corporate reports should be published as soon as is reasonably possible after the end of the period to which they refer.

(vii) Comparability. Corporate reports should be prepared in such a way as to enable users to make reasonable comparisons of the results of an entity over time as well as with the results of similar entities.

(b) In the absence of a generally accepted theory of accounting, a consideration of all the desirable characteristics is helpful in assessing the utility of corporate reports. Given the perceived needs of users, an agreement that accounts should be relevant might, for example, be a strong argument for the preparation of accounts which reflect current values rather than historical costs.

The list of desirable characteristics can be viewed as a useful framework for assessing different systems, but it is not, of itself, sufficient to resolve all problems or to enable the estalbishment of clear and unambiguous rules of procedure. One major problem is that there may be some conflict between the different characteristics. The desire to produce timely accounts may conflict with the wish to prepare complete accounts. Similarly, there may be a conflict between relevance and reliability.

Thus the identification of desirable characteristics will not eliminate the need to make judgements about financial accounting methods. However, the process provides a set of criteria against which the necessary judgements can be made and hence might be expected to improve financial reporting.

(c) Two examples where the economic substance of a transaction may be recognized in preference to its legal form are:

(i) The inclusion in a balance sheet of fixed assets which are the subject of a hire purchase contract or finance lease where the legal title has not yet passed to the company.

(ii) The inclusion in stock of items in respect of which the legal title has not yet passed to the company because, for example, the necessary legal documentation has not been completed.

2 Sources of authority

QUESTION 2.1

(a) Four fundamental concepts

Going concern: Under this concept the accounts are drawn up on the basis that the enterprise will continue in operational existence for the foreseeable future. Thus the accountant does not prepare accounts which show what the various assets would realize on a liquidation or on the assumption of a fundamental change in the nature of the business. Rather he assumes that the business will continue to do the same sort of things that it has done in the past.

Accruals: Under this concept, revenues and expenses are recognized when they are earned or incurred, not when amounts are received or paid. So revenues are usually recognized when there is a transaction with a third party while expenses are matched against the revenues in the period to which they relate.

Consistency: This concept has two aspects. Like items must be treated in the same way in a set of accounts. In addition, they must be treated in the same way if they occur in different accounting periods so as to achieve comparability over time.

Prudence: This concept requires that we do not take credit for revenue until it has been realized in cash or near cash, that is assets which are reasonably certain to be converted into cash, but that we do provide for all known liabilities whether or not we know with certainty the amount of the liability. The effect of this assymetrical approach is to introduce a bias which understates, rather than overstates, profits.

(b) Three other concepts

Substance over form: Under this concept, accountants are required to account for the economic substance of a transaction or event rather than to account merely for its legal form. So, for example, where a lessee leases a fixed asset for the whole of its useful life and takes on substantially all the risks and rewards of ownership, it would be necessary to show in the balance sheet both an asset and an obligation to make payments even though legally the lessee does not own the asset.

Materiality: Under this concept, accountants need only concern themselves with material items and need not bother with immaterial items. What is or is not material is difficult to define and must depend upon the particular circumstances but, in general terms, an item will be material if knowledge of it would be likely to influence the user of the financial statements.

Stable monetary unit: In conventional historical cost accounts, the accountant assumes that the monetary unit is stable. Hence under this concept changes in the purchasing power of money are ignored.

(c) Abandoning a concept

Users of accounts are entitled to rely on the fact that the four fundamental accounting concepts listed in (a) above have been used in preparing a set of accounts. However this does not mean that the concepts should be applied if they are not appropriate in the circumstances but, where they are not applied, users of the accounts must be given clear notice of the fact.

One of the four concepts is the going concern concept. If the position of a company is such as to indicate that it will not continue in operational existence in the foreseeable future, then it would be incorrect to use this concept. Instead it would be necessary to value assets at their break-up values and to indicate clearly to users what had been done and why it had been done.

QUESTION 2.2

Short memoranda

(1) Albatross Ltd - Accruals concept:

To: The Directors of Albatross Ltd Date: November 1st, 1983
From: A.N. Other
Subject: Expenses charged in profit and loss account

In arriving at the profit for the year ended 30th June 1983, the following two amounts have been charged:

	£
General rates for the year to 31st March 1984	16,400
Rent for quarter to 30th September 1983	15,000

The charging of these amounts is not in accordance with the 'accruals' concept under which expenses are charged to the profit and loss account, not in the period when they are paid, but in the period to which they relate.

In the case of the general rates the expenditure covers the period 1st April 1983 to 31st March 1984. Hence, at 30th June 1983 three quarters of the amount paid represents a prepayment in respect of the nine months from 1st July 1983 to 31st

March 1984. This amount should not be charged in the profit and loss account for the year to 30 June 1983 but carried forward as a prepayment to be charged in the profit and loss account for the following year. Thus, the general rate expense should be reduced by £12,300 (3/4 of 16,400) and this prepayment should be included in the balance sheet as a current asset.

Similarly, the amount of £15,000 paid in respect of rent relates to the three months ended 30th September 1983 and should not be charged in the current profit and loss account but carried forward as a prepayment to be charged in the profit and loss account for the subsequent year.

(2) Eagle Ltd - Consistency concept:

To:	The Directors of Eagle Ltd	Date:	November 1st, 1983
From:	A.N. Other		
Subject:	Change in basis of valuing work-in-progress		

The standard accounting practice on the valuation of work-in-progress requires that it be valued at cost or lower net realizable value. Cost is defined to include both direct costs and relevant production overheads. On 31st July 1983, the work-in-progress has been correctly valued on this basis and includes overheads of £60,000.

However, on 31st July 1982 the work-in-progress was valued on the basis of direct cost only and hence the basis of valuation has changed during the year.

The above treatment is contrary to the fundamental accounting convention of 'consistency', which requires, inter alia, that items be valued on a consistent basis over time. This does not mean that change in accounting is impossible but that where such a change is made, an adjustment is made to revise the opening figure onto a consistent basis. It follows that the opening figure should be increased to £495,000 (£495,000 + £45,000) and reserves adjusted accordingly. Hence, the reported profit for the year will be reduced by £45,000.

The fact that there has been a change in accounting policy should be explained in the notes to the accounts.

(3) Birdie Ltd - Prudence concept:

To:	The Directors of Birdie Ltd	Date:	November 1st 1983
From:	A.N. Other		
Subject:	Goods on sale or return		

The sales figure in the profit and loss account for the year ended 31st May 1983 includes sales of £40,000 to customers on a sale or return basis. It follows that the reported profit includes the profit on these 'sales.' However, given the basis on which the goods have been sent to customers, there is the possibility that the goods will be returned, in which case the profit will not be earned.

There is a fundamental accounting convention of prudence under which accountants do not take credit for profits until they are 'realized' and profits would not be considered to be realized until a sale is actually made.

A provision for the unrealized profit should be made, thus reducing the reported profit figure. The debtors figure would then be reduced by £40,000 and that amount, less the provision for unrealized profit, should be shown as stock with customers at cost.

(4) Underpar Ltd - Going concern concept:

To:	Directors of Underpar Ltd	Date:	November 1st 1983
From:	A.N. Other		
Subject:	Continuity of the company		

In the company's balance sheet on 31st August 1983, the stocks and work-in-progress have been included at their cost, which includes apportioned overheads. This is the normal basis of valuing stocks and work-in-progress in accounts unless the net realizable value is lower. However, accounts are normally prepared in accordance with the going concern concept.

The going concern concept is a difficult concept to describe although one well understood by accountants. Under the concept, the assets of the company are valued on a cost basis and they are not valued at the prices they would fetch if sold.

In our view, the company cannot be described as a going concern and hence the going concern basis is not an appropriate one to use. Instead, the accounts should be prepared on a different basis, namely on the basis that the company will be liquidated.

All assets of the company should be valued at their sale value, thus reducing the balance sheet values and the reported profits of the company.

QUESTION 2.3(a)

Arguments for:

There are arguments for standard setting in general and arguments for standard setting by a semi-official body rather than by the government.

(i) As a result of a number of accounting scandals in the 1960s, the public discovered that accounting is an art rather than an exact science. The public became aware that, within the law, accountants had an enormous amount of flexibility and there were considerable pressures to narrow down the available choice. A restriction of choice was considered to be necessary to reduce the possibility of bias or manipulation and to make the comparison of the accounts of different companies more accurate. Such a reduction in flexibility could have been undertaken by statute law or by a semi-official body representative of the accountancy profession. The latter course was taken in the UK and the advantages of this are as follows.

(ii) Accountants know most about accounting and are therefore the best people to standardize accounting. Only accountants have the necessary expertise to be able to understand the problems and to know what is and is not possible.

(iii) Accounting thought and practice is continuously developing and there must be development and change in accounting standards if accounts are to provide useful information. If standards were embodied in law, it would be difficult for the government to find sufficient parliamentary time to change them. Standards written by a body of professional accountants' that is in touch with current developments, can respond more quickly to developments and we have seen examples of such changes with many topics, e.g. deferred taxation, price changes.

Arguments against:

There are arguments against any form of standardization and arguments against standard setting by a body representative of professional accountants.

(i) Some people would argue that there should be no mandatory accounting standards at all. They would argue that the business world is very complex and that accountants should think about how best to portray the underlying business reality in the accounts. If accounting methods are standardized there is a danger that accountants will cease to consider this basic problem but will instead resort to the "book of rules" and apply them whether appropriate or not. This may lead to a deterioration in the quality of accountants and to an ossification of accounting.

(ii) Some would argue that a professional body of accountants is not sufficiently independent to set standards. Such a body may bow to pressure from clients and/or give undue recognition to their own self interest.

(iii) Once the ASC has set standards, it has little power or resources to enforce them. An audit report qualified for non-compliance with an accounting standard may often have little effect, and professional accountancy bodies appear to have been somewhat loath to take disciplinary action against their members for breach of standards. Hence enforcement of compliance with standards is difficult for a body like the ASC.

QUESTION 2.3(b)

In the past, the main documents issued by the Accounting Standards Committee have been Exposure Drafts and Statements of Standard Accounting Practice, although Discussion Papers have been issued on a number of subjects such as accounting for goodwill and a review of SSAP 6. These are to be joined by the two new statements, the SOI and the SORP.

SOI

This is a brief statement of the way in which the ASC intends to deal with a particular topic in a future SSAP or SORP. It does not include the text of the SSAP or SORP but provides a brief summary to inform interested parties of the intended approach to a particular subject. The issue of such a SOI is optional and is not intended to replace the ED, SSAP or SORP.

In view of the fact that the ASC is now dealing with complex problems and the consequent long periods of time required to prepare a standard, the issue of a SOI can only help users to appreciate what is happening and to plan accordingly. A number of SOIs have already been issued, for example on accounting for acquisition and mergers and accounting for pension costs.

SORP

SSAPs will continue to be issued to deal with matters of major and fundamental importance which affect the generality of companies. A completely new statement, the SORP, will deal with topics which are not of sufficient importance to warrant the issue of a SSAP. These SORPs will be issued either for matters which are of widespread application but not of fundamental importance or for matters which are of limited application to, for example, specific industries or particular areas of the public sector. In the case of those SORPs covering matters of limited application, it is intended that the SORP be prepared by representatives of the specific industry or particular area of the public sector and then 'franked', that is approved, by the ASC.

SORPs are not mandatory and non-compliance will not require disclosure or a qualified audit report. Rather they hark back to the earlier recommendations of the professional accountancy bodies and it is hoped that they will command respect as representing best practice in the particular area.

It is hoped that the introduction of the SORP will permit the ASC to concentrate on matters of fundamental importance, thus spending less of its time on matters of peripheral or limited interest.

QUESTION 2.4

(a) Objectives of IASC

Under a revised agreement in 1982 the objectives of the IASC are now:

(i) To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their world wide acceptance and observance;

(ii) To work generally for improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements.

Members enter into an undertaking to support the work of IASC by publishing in their respective countries every IAS approved for issue by the Board of IASC and by using their best endeavours:

(i) To ensure that published financial statements comply with IASs in all material respects and disclose the fact of such compliance;

(ii) To persuade governments and standard-setting bodies that published financial statements should comply with IASs in all material respects;

(iii) To persuade authorities controlling securities markets and the industrial and business community that published financial statements should comply with IASs in all material respects and disclose the fact of such compliance;

(iv) To ensure that auditors satisfy themselves that the financial statements comply with IASs in all material respects;

(v) To foster acceptance and observance of IASs internationally.

(b) Difficulties

In drafting accounting standards, the ASC must consider the legal and business framework in the UK/Ireland while the IASC must consider the environments of all its member countries. It is therefore quite possible that a SSAP and an IAS on the same subject may differ from one another.

The order of priority and pace of work of the ASC and the IASC differ and it is therefore possible that there will be a UK/Irish SSAP on some topics on which there is no IAS. Conversely there may be an IAS on some topics on which there is no SSAP, e.g. IAS 14 Reporting financial information by segment.

Formally the above position gives rise to no difficulties for preparers of accounts. Companies in the UK and Ireland are required to comply with SSAPs but they are only required to comply with IASs to the extent necessary by UK law or when incorporated in SSAPs by the ASC. IASs do not override UK/Irish law and standards.

(c) Reconciliation

The IASC works closely with the bodies responsible for standard setting in member countries and draws up its standards in the light of the standards already in existence or proposed in those member countries. Given the importance of the ASC, the IASC would study the UK/Irish position before promulgating its own standards.

The IASC attempts to concentrate upon the broader issues and tries not to become too involved in detailed requirements which might make international standardization impossible. It would therefore be expected that the UK/Irish standard on any topic would be more restrictive than the corresponding IAS.

In promulgating SSAPs the ASC consider any relevant IAS on the particular subject. In almost all cases, compliance with the SSAPs has ensured compliance with the IAS and a note in the SSAP makes this clear. One exception concerns research and development. IAS 9 requires the disclosure of the total of research and development costs charged as expenses while this is not required by SSAP 13. UK/Irish companies are therefore under no obligation to disclose such an amount.

QUESTION 2.5

(1) Depreciation

The Companies Act requires that provision for depreciation be made in respect of all fixed assets with a limited useful economic life. The depreciation policy must *systematically* write off the cost of the asset less its estimated residual value over the expected life.

The balance sheet must contain a figure for tangible fixed assets and, in addition, either the balance sheet or the notes to the accounts must show the cost and accumulated depreciation in respect of the major categories of fixed assets. It is also necessary to disclose the depreciation of fixed tangible and intangible assets in some of the profit and loss account formats and, in the notes, it is necessary to show the current amounts provided in respect of the major categories of fixed assets. The Act also requires notes of accounting policies and depreciation would be an important part of these notes.

SSAP 12 requires that companies provide for depreciation on fixed assets which have a finite useful life although an exception is made in the case of investment properties. Under SSAP 19 a special treatment is proposed for investment properties