Answers

1 (a) Beth Group
Consolidated Balance Sheet at 30 November 2007

	Beth $m
Assets	
Non-current assets	
Property, plant and equipment (1,900 + 12 – 2)	1,910
Intangible assets	300
Goodwill	14
Investment in associate	183
	2,407
Current assets	
Inventories	900
Trade receivables (600 + 60 – 1 + 50)	709
Cash and cash equivalents	540
	2,149
Total assets	4,556
Share capital of $1	1,500
Other reserves (300 + 9)	309
Retained earnings	447
Minority interest	62
	2,318
Non-current liabilities (700 + 11 + 2)	713
Current liabilities (1,380 + 100 + 45)	1,525
Total liabilities	2,238
Total equity and liabilities	4,556

Working 1

Goodwill calculation – Lose

HKFRS3, 'Business Combinations' requires that each share exchange transaction be treated separately by the acquirer using the cost of the transaction and the fair value of the assets, liabilities, and contingent liabilities at the date of each transaction to determine goodwill.

	1 Dec 2005			1 Dec 2006	
	$m	$m		$m	$m
Purchase consideration		40			160
less net assets acquired					
Share capital	100		Share capital	100	
Retained earnings	80		Retained earnings	150	
	180			250	
20% thereof		(36)	60% thereof		(150)
Goodwill		4	Goodwill		10

Total Goodwill ($4 million + $10 million) i.e. $14 million

Working 2

Minority Interest

20% of $(100 + 200 + 10 – 2) million $61·6 million

Working 3

Group Reserves at 30 November 2007

	$m
Retained earnings – Beth	400
Post acquisition reserves – Lose	
(200 + 10 – 2 – 80) x 20%	25·6
(200 + 10 – 2 – 150) x 60%	34·8
Impairment of associate (working 4)	(6)
Associate's profit less inter company (12 – 3)	9
Loss on monetary item – foreign currency (working 6)	(1)
Factor – reversal of entry (working 7)	5
Share options (working 8)	(9)
Provision (working 9)	(11)
Retained earnings at 30 November 2007	447·4

Working 4

Associate investment in Gain

Equity Method	$m
Cost of investment	180
Profit $(300 – 260)m x 30%	12
	192
less inter company profit (working 5)	(3)
Carrying value in balance sheet	189

Goodwill is not recognised separately in the carrying amount of the investment and not tested for impairment separately. The carrying amount of the investment and the recoverable amount are compared.

	$m
Carrying value	189
Recoverable amount ($610m x 30%)	(183)
Impairment	6

Working 5: Inter company profit

HKAS28 requires profits and losses resulting from transactions between the investor and an associate to be recognised in the investor's financial statements only to the extent of the unrelated investor's interests in the associate. Effectively part of Beth's profit on the sale is eliminated to the extent of the company's shareholding in Gain.

	$m
Inventory: selling price	28
Cost	(18)
Profit	10

Profit eliminated $10 million x 30%, i.e.	$3 million
DR Income statement/retained earnings	$3 million
CR Investment in associate	$3 million

Working 6 Deposit paid

If the payment to the supplier is a deposit and is refundable, then the amount is deemed to be a monetary amount which should be retranslated at the year end.

Deposit paid 50% x 12 million euros ÷ 0·75 = $8 million

At 30 November 2007, the deposit would be retranslated at 6 million euros ÷ 0·85, i.e. $7 million. Therefore, there will be an exchange loss of $(8 – 7) million, i.e. $1 million.

DR Retained earnings	$1 million
CR Trade receivables	$1 million

Working 7 Factored trade receivables

HKAS39 requires derecognition of a financial asset if the contractual rights to the cash flows have expired or the financial asset has been transferred and so have the risks and rewards of ownership of the asset. In the case of the sale of the trade receivables, the first criterion above has been met, but the second has not necessarily been met. Although the trade receivables are high quality debts, there is still a risk of default particularly as they are long dated, and that risk still lies with Beth. Therefore, the trade receivables should continue to be recognised and the monies received shown as a current liability. The reversing entries should be:

	$m
DR Trade receivables	50
CR Current liabilities	45
Retained earnings	5

Working 8 Share options

200 options x (10,000 – 1,100) x $^1/_2$ x $10 = <u>$8·9 million</u>

DR Retained earnings	$9 million	(rounded)
CR Equity	$9 million	

At the grant date, the fair value of the award is determined, but then at each reporting date until vesting, a best estimate of the cumulative charge to the income statement is made, taking into account:

(i) the grant date fair value of the award ($10 per option)
(ii) the current best estimate of the number of awards that will vest (89%)
(iii) the expired portion of the vesting period (1 year)

Working 9 Environmental provision

An enterprise must recognise a provision if, and only if:

(i) a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event)
(ii) payment is probable ('more likely than not'), and
(iii) the amount can be estimated reliably

In this case, a provision should be made to include the costs of contamination in the countries where the law is to be enacted or has been enacted as there will be a legal obligation in those countries. Moral obligations to rectify environmental damage do not justify making a provision. Therefore, a provision of $(7 + 4) million, i.e. <u>$11 million</u>, should be made.

DR Retained earnings	$11 million
CR Non-current liabilities	$11 million

Working 10 Operating Lease

Lose should capitalise the leasehold improvements of $10 million and depreciate them over the term of the lease in accordance with HKAS16 'Property, plant and equipment'. Because the improvements have occurred, an obligation arises out of the past event, and a provision of $2 million should be made for the conversion of the building back to its original condition.

Thus the following entries should be made in Lose's financial statements:

	$m
DR Property, plant and equipment	10
CR Income statement	10
DR Property, plant and equipment	2
CR Provision for 'decommissioning'	2

Depreciation on the capitalised amounts should be charged over the term of the lease as depreciation is charged in full on property, plant and equipment in the year of acquisition. Thus depreciation will be accounted for as follows:

	$m
DR Income Statement ($10m + $2m) ÷ 6 years	2
CR Property, plant and equipment	2

(b) An environmental report allows an organisation to communicate with different stakeholders. The benefits of an environmental report include:

(i) evaluating environmental performance can highlight inefficiencies in operations and help to improve management systems. Beth could identify opportunities to reduce resource use, waste and operating costs.

(ii) communicating the efforts being made to improve social and environmental performance can foster community support for a business and can also contribute towards its reputation as a good corporate citizen. At present Beth has a poor reputation in this regard.

(iii) reporting efforts to improve the organisation's environmental, social and economic performance can lead to increased consumer confidence in its products and services.

(iv) commitment to reporting on current impacts and identifying ways to improve environmental performance can improve relationships with regulators, and could reduce the potential threat of litigation which is hanging over Beth.

(v) investors, financial analysts and brokers increasingly ask about the sustainability aspects of operations. A high quality report shows the measures the organisation is taking to reduce risks, and will make Beth more attractive to investors.

(vi) disclosing the organisation's environmental, social and economic best practices can give a competitive market edge. Currently Beth's corporate image is poor and this has partly contributed to its poor stock market performance.

(vii) the international trend towards improved corporate sustainability is growing and access to international markets will require increasing transparency, and this will help Beth's corporate image.

(viii) large organisations are increasingly requiring material and service suppliers and contractors to submit performance information to satisfy the expectations of their own shareholders. Disclosing such information can make the company a more attractive supplier than their competitors, and increase Beth's market share.

It is important to ensure that the policies are robust and effective and not just compliance based.

(c) Corporate social responsibility (CSR) is concerned with business ethics and the company's accountability to its stakeholders, and about the way it meets its wider obligations. CSR emphasises the need for companies to adopt a coherent approach to a range of stakeholders including investors, employees, suppliers, and customers. Beth has paid little regard to the promotion of socially and ethically responsible policies. For example, the decision to not pay the SME creditors on the grounds that they could not afford to sue the company is ethically unacceptable. Additionally, Beth pays little regard to local customs and cultures in its business dealings.

The stagnation being suffered by Beth could perhaps be reversed if it adopted more environmentally friendly policies. The corporate image is suffering because of its attitude to the environment. Environmentally friendly policies could be cost effective if they help to increase market share and reduce the amount of litigation costs it has to suffer. The communication of these policies would be through the environmental report, and it is critical that stakeholders feel that the company is being transparent in its disclosures.

Evidence of corporate misbehaviour (Enron, World.com) has stimulated interest in the behaviour of companies. There has been pressure for companies to show more awareness and concern, not only for the environment but for the rights and interests of the people they do business with. Governments have made it clear that directors must consider the short-term and long-term consequences of their actions, and take into account their relationships with employees and the impact of the business on the community and the environment. The behaviour of Beth will have had an adverse effect on their corporate image.

CSR requires the directors to address strategic issues about the aims, purposes, and operational methods of the organisation, and some redefinition of the business model that assumes that profit motive and shareholder interests define the core purpose of the company. The profits of Beth will suffer if employees are not valued and there is poor customer support.

Arrangements should be put in place to ensure that the business is conducted in a responsible manner. The board should look at broad social and environmental issues affecting the company and set policy and targets, monitoring performance and improvements.

2 **Report to the Directors of Macaljoy plc**

Terms of Reference

This report sets out the differences between a defined contribution and defined benefit plan, and the accounting treatment of the company's pension plans. It also discusses the principles involved in accounting for warranty claims, and the accounting treatment of those claims.

(a) Pension plans – HKAS19

A defined contribution plan is a pension plan whereby an employer pays fixed contributions into a separate fund and has no legal or constructive obligation to pay further contributions (HKAS19 paragraph 7). Payments or benefits provided to employees may be a simple distribution of total fund assets, or a third party (an insurance company) may, for example, agree to provide an agreed level of payments or benefits. Any actuarial and investment risks of defined contribution plans are assumed by the employee or the third party. The employer is not required to make up any shortfall in assets and all plans that are not defined contribution plans are deemed to be defined benefit plans.

Defined benefit, therefore, is the residual category whereby, if an employer cannot demonstrate that all actuarial and investment risk has been shifted to another party and its obligations limited to contributions made during the period, then the plan is a defined benefit plan. Any benefit formula that is not solely based on the amount of contributions, or that includes a guarantee from the entity or a specified return, means that elements of risk remain with the employer and must be accounted for as a defined benefit plan. An employer may create a defined benefit obligation where no legal obligation exists if it has a practice of guaranteeing the benefits. An employer's obligation under a defined benefit plan is to provide the agreed amount of benefits to current and former employees. The differentiating factor between defined benefit and defined contribution schemes is in determining where the risks lie.

In a defined benefit scheme it is the employer that underwrites the vast majority of costs so that if investment returns are poor or costs increase the employer needs to either make adjustments to the scheme or to increase levels of contribution. Alternatively, if investment returns are good, then contribution levels could be reduced. In a defined contribution scheme the

contributions are paid at a fixed level and, therefore, it is the scheme member who is shouldering these risks. If they fail to take action by increasing contribution rates when investment returns are poor or costs increase, then their retirement benefits will be lower than they had planned for.

For defined contribution plans, the cost to be recognised in the period is the contribution payable in exchange for service rendered by employees during the period. The accounting for a defined contribution plan is straightforward because the employer's obligation for each period is determined by the amount to be contributed for that period. Often, contributions are based on a formula that uses employee compensation in the period as its base. No actuarial assumptions are required to measure the obligation or the expense, and there are no actuarial gains or losses.

The employer should account for the contribution payable at the end of each period based on employee services rendered during that period, reduced by any payments made during the period. If the employer has made payments in excess of those required, the excess is a prepaid expense to the extent that the excess will lead to a reduction in future contributions or a cash refund.

For defined benefit plans, the amount recognised in the balance sheet should be the present value of the defined benefit obligation (that is, the present value of expected future payments required to settle the obligation resulting from employee service in the current and prior periods), as adjusted for unrecognised actuarial gains and losses and unrecognised past service cost, and reduced by the fair value of plan assets at the balance sheet date. If the balance is an asset, the amount recognised may be limited under HKAS19.

In the case of Macaljoy, the 1990 plan is a defined benefit plan as the employer has the investment risk as the company is guaranteeing a pension based on the service lives of the employees in the scheme. The employer's liability is not limited to the amount of the contributions. There is a risk that if the investment returns fall short the employer will have to make good the shortfall in the scheme. The 2006 plan, however, is a defined contribution scheme because the employer's liability is limited to the contributions paid.

A curtailment occurs when an entity either

(a) is demonstrably committed to making a material reduction in the number of employees covered by a plan, or

(b) amends the terms of a defined benefit plan.

An amendment would be such that a material element of future service by current employees will no longer qualify for benefits or qualify for reduced benefits. Curtailments, by definition, have a material impact on the entity's financial statements. The fact that no new employees are to be admitted to the 1990 plan does not constitute a curtailment because future service qualifies for pension rights for those in the scheme prior to 31 October 2006.

The accounting for the two plans is as follows. The company does not recognise any assets or liabilities for the defined contribution scheme but charges the contributions payable for the period ($10 million) to operating profit. The contributions paid by the employees will be part of the wages and salaries cost and when paid will reduce cash. The accounting for the defined benefit plan results in a liability of $15 million as at 31 October 2007, a charge in the statement of recognised income and expense of $5·3 million, and an expense in the income statement of $16·7 million for the year (see Appendix 1).

(b) Provisions – HKAS37

An entity must recognise a provision under HKAS37 if, and only if:

(a) a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event)

(b) it is probable ('more likely than not'), that an outflow of resources embodying economic benefits will be required to settle the obligation

(c) the amount can be estimated reliably

An obligating event is an event that creates a legal or constructive obligation and, therefore, results in an enterprise having no realistic alternative but to settle the obligation. A constructive obligation arises if past practice creates a valid expectation on the part of a third party. If it is more likely than not that no present obligation exists, the enterprise should disclose a contingent liability, unless the possibility of an outflow of resources is remote.

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date, that is, the amount that an enterprise would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party. This means provisions for large populations of events such as warranties, are measured at a probability weighted expected value. In reaching its best estimate, the entity should take into account the risks and uncertainties that surround the underlying events.

Expected cash outflows should be discounted to their present values, where the effect of the time value of money is material using a risk adjusted rate (it should not reflect risks for which future cash flows have been adjusted). If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised as a separate asset when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The amount recognised should not exceed the amount of the provision. In measuring a provision future events should be considered. The provision for the warranty claim will be determined by using the expected value method.

The past event which causes the obligation is the initial sale of the product with the warranty given at that time. It would be appropriate for the company to make a provision for the Year 1 warranty of $280,000 and Year 2 warranty of $350,000, which represents the best estimate of the obligation (see Appendix 2). Only if the insurance company have validated the counter claim will Macaljoy be able to recognise the asset and income. Recovery has to be virtually certain. If it is virtually certain, then Macaljoy may be able to recognise the asset. Generally contingent assets are never recognised, but disclosed where an inflow of economic benefits is probable.

The company could discount the provision if it was considered that the time value of money was material. The majority of provisions will reverse in the short term (within two years) and, therefore, the effects of discounting are likely to be immaterial. In this case, using the risk adjusted rate (HKAS37), the provision would be reduced to $269,000 in Year 1 and $323,000 in Year 2. The company will have to determine whether this is material.

Appendix 1

The accounting for the defined benefit plan is as follows:

	31 October 2007	1 November 2006
	$m	$m
Present value of obligation	240	200
Fair value of plan assets	(225)	(190)
Liability recognised in balance sheet	15	10

Expense in Income Statement year ended 31 October 2007:

	$m
Current service cost	20
Interest cost	10
Expected return on assets	(13·3)
Expense	16·7

Analysis of amount in Statement of Recognised Income and Expense:

	$m
Actuarial loss on obligation (w2)	29
Actuarial gain on plan assets (w2)	(23·7)
Actuarial loss on obligation (net)	5·3

Appendix 2

Year 1 warranty

	Expected value $000	Discounted expected value (4%) $000
80% x Nil	0	
15% x 7,000 x $100	105	
5% x 7,000 x $500	175	
	280	269

Year 2 extended warranty

	Expected value $000	Discounted expected value (4%) $000
70% x Nil	0	
20% x 5,000 x $100	100	
10% x 5,000 x $500	250	
	350	323

Working 1

Movement in net liability in balance sheet at 31 October 2007:

	$m
Opening liability	10
Expense	16·7
Contributions	(17)
Actuarial loss	5·3
Closing liability	15

Working 2

Changes in the present value of the obligation and fair value of plan assets.

	31 October 2007
	$m
Present value of obligation at 1 November 2006	200
Interest (5% of 200)	10
Current service cost	20
Benefits paid	(19)
Actuarial loss on obligation	29
Present value of obligation at 31 October 2007	240
Fair value of plan assets at 1 November 2006	190
Expected return on assets (7% of 190)	13·3
Contributions	17
Benefits paid	(19)
Actuarial gain on plan assets	23·7
Fair value of plan assets at 31 October 2007	225

3 The company should account for the events as follows:

(a) The two manufacturing units meet the criteria for classification as held for sale and are, therefore, deemed to be a disposal group under HKFRS5 'Non-current Assets Held for Sale and Discontinued Operations' as the assets are to be disposed of in a single transaction.

The measurement basis required for non-current assets held for sale is applied to the group as a whole and any impairment loss will reduce the carrying amount of the non-current assets in the disposal group in the order of allocation required by HKAS36 'Impairment of Assets' (HKFRS5 paragraph 4). Before classification as held for sale, evidence of impairment will be tested on an individual cash generating unit basis, but after classification it will be done on a disposal group basis.

Immediately before the initial classification of the asset as held for sale, the carrying amount of the asset will be measured in accordance with applicable HKFRSs.

On classification as held for sale, disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. Impairment must be considered both at the time of classification as held for sale and subsequently. Immediately prior to classifying a disposal group as held for sale, it must measure and recognise impairment in accordance with the applicable HKFRSs. Any impairment loss is recognised in profit or loss unless the asset had been measured at a revalued amount under HKAS16 'Property, Plant and Equipment' or HKAS38 'Intangible Assets', in which case the impairment is treated as a revaluation decrease. On classification as held for sale, any impairment loss will be based on the difference between the adjusted carrying amounts of the disposal group and fair value less costs to sell. Any impairment loss that arises by using the measurement principles in HKFRS5 must be recognised in profit or loss (HKFRS5 paragraph 20).

Thus Ghorse should not increase the value of the disposal group above $105 million at 30 September 2007 as this is the carrying amount of the assets measured in accordance with applicable HKFRS immediately before being classified as held for sale (HKAS36 and HKAS16). After classification as held for sale, the disposal group will remain at this value as this is the lower of the carrying value and fair value less costs to sell, and there is no impairment recorded as the recoverable amount of the disposal group is in excess of the carrying value. At a subsequent reporting date following initial classification as held for sale the disposal group should be measured at fair value less costs to sell. However, HKFRS5 (paragraphs 21–22) allows any subsequent increase in fair value less costs to sell to be recognised in profit or loss to the extent that it is not in excess of any impairment loss recognised in accordance with HKFRS5 or previously with HKAS36. Thus any increase in the fair value less costs to sell can be recognised as follows at 31 October 2007:

	$m
Fair value less costs to sell – Cee	40
Fair value less costs to sell – Gee	95
	135
Carrying value	(105)
Increase	30
Impairment recognised in Cee (50 – 35)	15

Therefore, the carrying value of the disposal group can increase by $15 million and profit or loss can be increased by the same amount, where the fair value rises. Thus the value of the disposal group will be $120 million. These adjustments will affect 'Return on Capital Employed' (ROCE).

(b) The differences between the HKFRS carrying amounts for the non-current assets and tax bases will represent temporary differences.

The general principle in HKAS12 'Income Taxes' is that deferred tax liabilities should be recognised for all taxable temporary differences. A deferred tax asset should be recognised for deductible temporary differences, unused tax losses and unused tax credits to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised.

A deferred tax asset cannot be recognised where it arises from negative goodwill or the initial recognition of an asset/liability other than in a business combination. The carrying amount of deferred tax assets should be reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction should be subsequently reversed to the extent that it becomes probable that sufficient taxable profit will be available (HKAS12 paragraph 37)

The recognition of deferred tax assets will result in the recognition of income, in the income statement. This amount cannot be reported in equity as HKAS12 only allows deferred tax to be recognised in equity if the corresponding entry is recognised in equity. This is not the case in this situation as the revaluation was not recognised for HKFRS purposes.

	Carrying Amount $m	Tax Base $m	Temporary Difference $m
Property	50	65	15
Vehicles	30	35	5
Other taxable temporary differences			(5)
			15

The deferred tax asset would be $15 million x 30%, i.e. $4·5 million subject to there being sufficient taxable profit. The deferred tax provision relating to these assets would have been:

	Carrying Amount $m	Tax Base $m	Temporary Difference $m
Property	50	48	2
Vehicles	30	28	2
			4
Other taxable temporary differences			5
			9

$9 million at 30%, i.e. $2·7 million

The impact on the income statement would be significant as the deferred tax provision of $2·7 million would be released and a deferred tax asset of $4·5 million credited to it. These adjustments will not affect profit before interest and tax. However an asset of $4·5 million will be created in the balance sheet which will affect ROCE.

(c) At each balance sheet date, Ghorse should review all assets to look for any indication that an asset may be impaired, i.e. where the asset's carrying amount ($3 million) is in excess of the greater of its net selling price and its value in use. HKAS36 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, then the asset's recoverable amount must be calculated (HKAS36 paragraph 9).

The recoverable amount is the higher of an asset's fair value less costs to sell (sometimes called net selling price) and its value in use which is the discounted present value of estimated future cash flows expected to arise from:

(i) the continuing use of an asset, and from
(ii) its disposal at the end of its useful life

If the manufacturer has reduced the selling price, it does not mean necessarily that the asset is impaired. One indicator of impairment is where the asset's market value has declined significantly more than expected in the period as a result of the passage of time or normal usage. The value-in-use of the equipment will be $4·7 million.

Year ended 31 October	Cash flows $m	Discounted (10%) $m
2008	1·3	1·2
2009	2·2	1·8
2010	2·3	1·7
Value in use	–	4·7

The fair value less costs to sell of the asset is estimated at $2 million. Therefore, the recoverable amount is $4·7 million which is higher than the carrying value of $3 million and, therefore, the equipment is not impaired with no effect on ROCE.

(d) Under HKAS17, 'Leases', operating lease payments should be recognised as an expense in the income statement over the lease term on a straight line basis, unless another systematic basis is more representative of the time pattern of the user's benefit.

The provisions of the lease have changed significantly and would need to be reassessed.

The lease term is now for the major part of the economic life of the assets, and at the inception of the lease, the present value of the minimum lease payments is substantially all of the fair value of the leased asset. (Fair value $35 million, NPV of lease payments $34·1 million) Even if title is not transferred at the end of the lease the lease can still be a finance lease. Any change in the estimate of the length of life of a lease would not change its classification but where the provisions of the lease have changed, re-assessment of its classification takes place. Thus it would appear that the lease is now a finance lease, and it would be shown in the balance sheet at the present value of the lease payments as this is lower than the fair value. This change in classification will not affect ROCE as it will increase non-current assets by $34·1 million and liabilities by the same amount.

Effect on ROCE

	$m
Profit before tax and interest	30
add increase in value of disposal group	15
	45
Capital employed	220
add increase in value of disposal group	15
Deferred tax asset (4·5 + 2·7)	7·2
	242·2

ROCE will rise from 13·6% to 18·6% (45/242·2) and thus the directors' fears that ROCE would be adversely affected are unfounded.

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 difficulties converging their standards if decisions are based on different frameworks. The IASB has been pursuing a number of projects that are aimed at achieving short term convergence on certain issues with national standard setters as well as major projects with them. Convergence will be difficult if there is no consistency in the underlying framework being used.

Frameworks differ in their authoritative status. The Framework in Hong Kong requires management to expressly consider the Framework if no standard or interpretation specifically applies or deals with a similar and related issue. However, certain frameworks have a lower standing. For example, entities are not required to consider the concepts embodied in certain national frameworks in preparing financial statements. Thus the development of an agreed framework would eliminate differences in the authoritative standing of conceptual frameworks and lead to greater consistency in financial statements internationally.

The existing concepts within most frameworks are quite similar. However, these concepts need revising to reflect changes in markets, business practices and the economic environment since the concepts were developed. The existing frameworks need developing to reflect these changes and to fill gaps in the frameworks. For example, the Framework does not contain a definition of the reporting entity. An agreed international framework could deal with this problem, especially if priority was given 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 accounting standards without an accepted theoretical frame of reference. The result has been inconsistency in the development of standards both nationally and internationally. The frameworks were developed when several of their current standards were in existence. In the absence of an agreed conceptual framework the same theoretical issues are revisited on several occasions by standard setters. The result is inconsistencies and incompatible concepts. Examples of this are substance over form and matching versus prudence. Some standard setters permit two methods of accounting for the same set of circumstances. An example is the accounting for joint ventures where the equity method and proportionate consolidation are allowed.

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 on general principles. A robust framework might reduce the need for detailed rules although some companies operate in a different legal and statutory context than other entities. It is important that a framework must result in standards that account appropriately 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 resolving accounting 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 resolving accounting and reporting issues. A framework provides a basic reasoning on which to consider the merits of alternatives. It does not provide all the answers, but narrows the range of alternatives to be considered by eliminating some that are inconsistent with it. It, thereby, contributes to greater efficiency in the standard setting process by avoiding the necessity of having to redebate fundamental issues and facilitates any debate about specific technical issues. A framework should also reduce political pressures in making accounting judgements. The use of a framework reduces the influence of personal biases in accounting decisions.

However, concepts statements are by their nature very general and theoretical in their wording, which leads to alternative conclusions being drawn. Whilst individual standards should be consistent with the Framework, in the absence of a specific standard, it does not follow that concepts will provide practical solutions. Hong Kong standards (HKAS8) set 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 the conceptual framework, but can also use accounting standards issued by other bodies. Thus an international framework may not totally 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 of users and whether decision usefulness is the key criteria or stewardship. Additionally there is the question of whether the 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 usefulness of financial reports is determined by these characteristics. There are issues concerning the trade-offs between relevance and reliability. An example of this concerns the use of fair values and historical costs. It has been argued that historical costs are more reliable although not as relevant as fair values. Additionally there is a conflict between neutrality and the traditions of prudence or conservatism. These characteristics are constrained by materiality and benefits that justify costs.

(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 underlying asset? Some standards contravene their own conceptual framework. IFRS3 requires the capitalisation of goodwill as an asset despite the fact that it can be argued that goodwill does not meet the definition of an asset. The recognition of deferred tax liabilities does not meet the liability definition. Similarly equity and liabilities need to be capable of being clearly distinguished. Certain financial instruments could either be liabilities 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 have recognition criteria, but there are issues over the timing of recognition. For example, should an asset be recognised when a value can be placed on it or when a cost has been incurred? If an asset or liability does not meet recognition criteria when acquired or incurred, what subsequent event causes the asset or liability to be recognised? Most frameworks do not discuss de-recognition. It can be argued that an item should be de-recognised when it does not meet the recognition criteria, but financial instruments standards require other factors to occur before financial assets can be de-recognised. Different attributes should be considered such as legal ownership, control, risks or rewards.

(v) Measurement
More detailed discussion of the use of measurement concepts, such as historical cost, fair value, current cost, etc are required and also more guidance on measurement techniques. Measurement concepts should address initial measurement and subsequent measurement in the form of revaluations, impairment and depreciation which in turn gives 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 included in consolidated financial statements. A question arises as to whether the legal entity or the economic unit should be the reporting unit. Complex business arrangements raise issues over what entities should be consolidated and the basis upon 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 the entity's future cash flows, its assets, liabilities and equity. It should provide management explanations and the limitations of the information in the reports. Discussions as to the boundaries of presentation and disclosure are required.

			Marks
1	**(a)**	Goodwill – Lose	5
		Minority interest	1
		Group reserves	2
		Associate and impairment	5
		Inter company profit	2
		Foreign currency	4
		Debt factoring	4
		Share options	4
		Provision	3
		Operating lease	3
		Other balance sheet items	2
		MAXIMUM	35
	(b)	Benefits of environmental report	8
	(c)	Discussion of ethical and social responsibilities	5
		Professional marks	2
		MAXIMUM	7
		MAXIMUM	50
2	**(a)**	Pensions (i) explanation	7
		(ii) calculation	7
	(b)	Provisions (i) explanation	6
		(ii) calculation	3
	Structure of report		2
	MAXIMUM		25
3	**(a)**	Disposal group	7
	(b)	Deferred tax asset	6
	(c)	Impairment	5
	(d)	Lease	5
		Formation of opinion of impact on ROCE	2
		MAXIMUM	25
4	**(a)**	Subjective	13
	(b)	up to 2 marks per key issue	10
		(i) Objectives	
		(ii) Qualitative characteristics	
		(iii) Definitions	
		(iv) Recognition and de-recognition	
		(v) Measurement	
		(vi) Reporting entity	
		(vii) Presentation and disclosure	
		Appropriateness and quality of discussion	2
		MAXIMUM	25