Answers

1 (a) Ashanti Group: Profit and Loss Account for the year ended 30 April 2010 (see working 1)

	Ashanti €m
Turnover	1,096
Cost of sales	(851)
Gross profit	245
Distribution costs	(64)
Administration expenses	(94·71)
Other operating income	54
Operating profit before interest	140·29
Loss on sale of operations	(9·44)
Profit from associate	2·1
Net interest costs	(33·31)
Profit on ordinary activities before tax	99·64
Taxation	(49)
Profit on ordinary activities after taxation	50·64
Minority Interest (W8)	(8·66)
Profit on ordinary activities after minority interest	41·98
Statement of Total Recognised Gains and Losses	
Profit for financial year	50·64
Available-for-sale financial assets (AFS)	32·6
Associate gain	0·9
Gains (net) on fixed assets revaluation	18·6
Actuarial losses on defined benefit plan	(14)
Total Recognised Gains and Losses for year	88·74

Total Recognised Gains and Losses attributable to:

	€m
Equity holders of the parent	73·99
Minority interest (W8) (8·66 + 6·09)	14·75
	88·74

Working 1

	Ashanti €m	Bochem €m	Ceram €m	Adjustment €m	Total €m
Turnover	810	235	71	(15)	
Revenue from illiquid customer	(5)				1,096
Inter company profit (€5m x 20%)	(1)				
Cost of sales	(686)	(137)	(42)	15	(851)
Gross profit	118	98	29		245
Distribution costs	(30)	(21)	(13)		(64)
Administrative expenses	(55)	(29)	(6)		
Mis-selling accrual (W7)	(0·21)				
Depreciation (W2)		(2)			
Loss on revaluation of plant and machinery (W6)	(0·6)				
Impairment of goodwill (W2)	(1·9)				(94·71)
Other income	31	17	6		54
Accrual of bond interest (W4)	1·67				
Impairment of bond (W4)	(13·98)				
Impairment of trade receivable	(3)				
Net interest costs	(8)	(6)	(4)		(33·31)
Sale of equity interest (W2)	8·06				
Loss on sale of Ceram (W3)		(17·5)			(9·44)
Share of profits of associate (W3)		2·1			2·1
Profit before tax	46·04	41·6	12		99·64
Income tax expense	(21)	(23)	(5)		(49)
Profit for the year	25·04	18·6	7		50·64
Statement of Total Recognised Gains and Losses					
Available-for-sale financial assets	20	9	3		32·6
Loss on bond now recognised	0·6				
Gains on property revaluation	12	6	–		
Revaluation adjustment	0·6				18·6
Actuarial losses on defined benefit plan	(14)	–	–		(14)
Share of associate available-for-sale financial assets (W3)		0·9			0·9
Recognised Gains and Losses	19·2	15·9	3		38·1
Total Recognised Gains and Losses	44·24	34·5	10		88·74

Working 2 Bochem

	€m
Fair value of consideration for 70% interest	150
Fair value of identifiable net assets acquired (70% of €160m)	(112)
Goodwill	38
Depreciation of plant	
Fair value of identifiable net assets	160
Book value (€55m + €85m + €10m)	(150)
Plant revaluation	10
Dr Profit or loss (€10 x 1/5)	2
Dr Retained earnings	2
Cr Accumulated depreciation	4
Goodwill impairment	
Up to 30 April 2009, €38m x 15%	€5·7 million
Further impairment up to 30 April 2010, €38 x 5%	€1·9 million
Total impairment	€7·6 million
Sale of equity interest in Bochem	
Fair value of consideration received	34
Less Net assets disposed (Net assets per question at year end €210m + Fair value of PPE at acquisition €10m – depreciation of fair value adjustment €4m) x 10%	(21·6)
Goodwill (38 – 7·6) x 10/70	(4·34)
Gain on disposal	8·06

Working 3 Ceram

	€m	€m
Fair value of consideration for 80% interest	136	
Indirect holding in Ceram – MI (30% of 136)	(40·8)	95·2
Fair value of identifiable net assets acquired (56% x €115m)		(64·4)
Goodwill		30·8

The fair value of the consideration held in Ceram represents the 80% shareholding purchased by Bochem. The 30% element that belongs to the MI of Bochem needs to be deducted thereby giving the net balance representing the effective 56% (70% of 80%) shareholding from the group viewpoint.

As Bochem has sold a controlling interest in Ceram, a gain or loss on disposal should be calculated. Additionally, the results of Ceram should only be consolidated in the profit and loss account for the six months to 1 November 2009. Thereafter Ceram should be equity accounted. However, goodwill could be calculated from the entity's perspective which would give a significantly different goodwill and gain/loss on disposal figure.

The loss recognised in the profit and loss account would be as follows:

	€m
Fair value of consideration	90
Less: net assets and goodwill derecognised	
net assets (160 x 50%)	(80)
goodwill (30·8 x 50/56)	(27·5)
Loss on disposal to profit or loss	(17·5)

The loss above has been calculated from Bochem's viewpoint and therefore a portion of this loss belongs to the MI of Bochem.

The share of the profits of the associate would be 30% of a half years' profit (€7m) i.e. €2·1 million and 30% of half of the gain on the AFS investments i.e. €0·9 million.

Working 4 Bond

	€m
Carrying value at 1 May 2009	20·45
Accrual of half year interest (4%) to 31 October 2009	0·82
	21·27
Accrual of half year interest (4%) to 30 April 2010	0·85
Carrying value at 30 April 2010	22·12
Interest accrual (0·82 + 0·85)	1·67
Fair value of bond at 30 April (€2·34m discounted at 10% + €8m discounted at 10% for two years)	8·74
Impairment of bond (22·12 – 8·74)	13·38
Reclassification of loss in equity	0·6
Impairment recognised in profit or loss	13·98

Note: the accrual of interest could also be based on the amortised cost at 1 May 2009 as an alternative to the carrying value.

Working 5

Ashanti should not record the revenue of €5 million, as it is not probable that economic benefit relating to the sale will flow to Ashanti. The revenue will be recorded when the customer pays for the goods. The cost of the goods will remain in the financial statements and the allowance for doubtful debts will be reduced to €3 million.

Working 6

	€m
Carrying value at 1 May 2009	13
Less depreciation for year	(1·44)
	11·56
Fall in value to depreciated historical cost to STRGL	(1·96)
Depreciated historical cost at end of year to April 2010	9·6
Fall in value to recoverable amount to P/L	(0·6)
	9
Fall in value – revaluation to STRGL	(1)
Value in balance sheet	8

The above treatment is applied where there is no obvious consumption of economic benefits as regards the fixed assets.

At 30 April 2009, a revaluation gain of (€13m – €12m – depreciation €1·2m) €2·2 million would be recorded in equity for the plant and machinery. At 30 April 2010, the value of the PPE would be €13m – depreciation of €1·44m i.e. €11·56m. Thus there will be a revaluation loss of €11·56m – €8m i.e. €3·56m. Of this amount €2·96 million (€1·96m + €1m) will be charged against revaluation surplus in reserves and €0·6 million will be charged to profit or loss.

Working 7

A provision should be made under FRS 12 for the mis-selling obligation as the costs clearly arise from a past event which was the sale of goods to the customers. Ashanti should provide for the fine and the amount anticipated to be paid to customers. The costs to improve the company's system and the training costs relate to the company's future operations and are not provided for.

Accrual is therefore €40,000 + €170,000 = €0·21m

Working 8

Minority interest (MI)

MI in profits for year is (30% of €18·6m + 44% of €7 million) =	€8·66m
MI in other recognised income is (30% x €15·9m + 44% of €3m) =	€6·09m
	€14·75m

(b) The Accounting Standards Board (ASB) has published amendments to FRS 26 Financial Instruments: Recognition and Measurement and FRS 29 Financial Instruments: Disclosures. The amendments are an attempt to create a 'level playing field' with US GAAP regarding the ability to reclassify financial assets. The changes to FRS 26 permit an entity to reclassify non-derivative financial assets out of the 'fair value through profit or loss' (FVTPL) and 'available-for-sale' (AFS) categories in limited circumstances. Such reclassifications will create additional disclosures. The amendments will only permit reclassification of certain non-derivative financial assets. Financial liabilities, derivatives and financial assets that are designated as at FVTPL on initial recognition under the 'fair value option' cannot be reclassified. The amendments therefore only permit reclassification of debt and equity financial assets subject to meeting specified criteria. The amendments do not permit reclassification into FVTPL or AFS at initial recognition.

A debt instrument that would have met the definition of loans and receivables, if it had not been required to be classified as held for trading at initial recognition, may be reclassified to loans and receivables if the entity has the intention and ability to hold the asset for the foreseeable future or until maturity. A debt instrument classified as AFS that would have met the definition of loans and receivables may be reclassified to the category if the entity has the same intention and ability as above. Any other debt instrument, or any equity instrument, may be reclassified from FVTPL to AFS, or from FVTPL to Held to Maturity (HTM) (in the case of debt instruments only), if the financial asset is no longer held for the purpose of selling in the near term – but only in 'rare' circumstances. The ASB acknowledged that volatile and illiquid market conditions are a possible example of a 'rare' circumstance.

All reclassifications must be made at the fair value of the financial asset at the date of reclassification. Any previously recognised gains or losses cannot be reversed. The fair value at the date of reclassification becomes the new cost or amortised cost of the financial asset, as applicable.

For reclassifications out of AFS, FRS 26 requires the amounts previously recognised in STRGL to be reclassified to profit and loss either through the effective interest rate or at disposal. Amounts deferred in equity may also need to be reclassified to profit or loss if there is impairment.

Allowing reclassification, even in limited circumstances, will allow an entity to manage its reported profit or loss by avoiding future fair value gains or losses on the reclassified assets. The intention of this is to ensure that previously impaired cash flows are reflected in the profit and loss account over the life of the asset rather than as immediate income effectively deferring the loss in the hope that economic conditions will improve. The ASB normally publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, the ASB decided to proceed directly to issuing the amendments without any due process. This exceptional step could lead to management of earnings by some entities as the amendments relax the existing requirements to provide 'short-term relief' for some entities. This relief effectively means that anticipated losses could be avoided by entities. It could be argued that the amendments are a short-term response to a current crisis, which because of the lack of exposure could lead to longer-term issues.

(c) 'Earnings management' has been defined in various ways. It can be described as the purposeful intervention in the external financial reporting process with the intent of obtaining some private gain. Alternatively it can be the use of judgment in financial reporting and in structuring transactions to alter financial reports to either mislead stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting judgments.

Incentives lie at the heart of earnings management. Managers should make accounting judgments and decisions solely with the intention of fairly reporting operating performance. However, there are often economic incentives for managers to engage in earnings management, because the value of the firm and the wealth of its managers or owners are normally linked to reported earnings. Contractual incentives to manage earnings arise when contracts between a company and other parties rely upon financial statements to determine financial exchanges between them. By managing the results of operations, managers can alter the amount and timing of those exchanges. Contractual situations could stimulate earnings management. These would

include debt covenants, management compensation agreements, job security, and trade union negotiations. Market incentives to manage earnings arise when managers perceive a connection between reported earnings and the company's market value. Regulatory incentives to manage earnings arise when reported earnings are thought to influence the actions of regulators or government officials. By managing the results of operations, managers may influence the actions of regulators or government officials, thereby minimising political scrutiny and the effects of regulation.

One way in which directors can manage earnings is by manipulation of accruals with no direct cash flow consequences. Examples of accrual manipulation include under-provisioning for irrecoverable debt expenses, delaying of asset write-offs and opportunistic selection of accounting methods. Accrual manipulation is a convenient form of earnings management because it has no direct cash flow implications and can be done after the year-end when managers are better informed about earnings. However, managers also have incentives to manipulate real activities during the year with the specific objective of meeting certain earnings targets. Real activity manipulation affects both cash flows and earnings.

Where management does not try to manipulate earnings, there is a positive effect on earnings quality. The earnings data is more reliable because management is not influencing or manipulating earnings by changing accounting methods, or deferring expenses or accelerating revenues to bring about desired short-term earnings results. The absence of earnings management does not, however, guarantee high earnings quality. Some information or events that may affect future earnings may not be disclosed in the financial statements. Thus, the concept of earnings management is related to the concept of earnings quality. One major objective of the ASB Statement of Principles is to assist investors and creditors in making investing and lending decisions. The Statement refers not only to the reliability of financial statements, but also to the relevance and predictive value of information presented in financial statements.

Entities have a social and ethical responsibility not to mislead stakeholders. Ethics can and should be part of a corporate strategy, but a company's first priority often is its survival and optimising its profits in a sustainable way. Management of earnings may therefore appear to have a degree of legitimacy in this regard but there is an obvious conflict. An ethical position that leads to substantial and long-term disadvantages in the market place will not be acceptable to an entity.

It is reasonable and realistic not to rely exclusively on personal morality. A suitable economic, ethical and legal framework attempts to ensure that the behaviour of directors conforms to moral standards. Stakeholders depend on the moral integrity of the entity's directors. Stakeholders rely upon core values such as trustworthiness, truthfulness, honesty, and independence although these cannot be established exclusively by regulation and professional codes of ethics. Thus there is a moral dilemma for directors in terms of managing earnings for the benefit of the entity, which might directly benefit stakeholders and themselves whilst at the same time possibly misleading the same stakeholders.

2 (a) Deferred taxation

A deferred tax asset should be recognised if it is more likely than not that it will be recovered. A key requirement of FRS 19 'Deferred Tax' is that deferred tax assets should only be 'recognised' to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable profits from which the future reversal of the underlying timing differences can be deducted. The recognition of deferred tax assets on losses carried forward does not seem to be in accordance with FRS 19. Cate is not able to provide convincing evidence that sufficient taxable profits will be generated against which the unused tax losses can be offset. According to FRS 19 the existence of unused tax losses is strong evidence that future taxable profit may not be available against which to offset the losses. Therefore when an entity has a history of recent losses, the entity recognises deferred tax assets arising from unused tax losses only to the extent that the entity has evidence that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted. As Cate has a history of recent losses and as it does not have sufficient taxable temporary differences, Cate needs to provide convincing other evidence that sufficient taxable profit would be available against which the unused tax losses could be offset. The unused tax losses in question did not result from identifiable causes, which were unlikely to recur as the losses are due to ordinary business activities. Additionally there are no tax planning opportunities available to Cate that would create taxable profit in the period in which the unused tax losses could be offset (FRS 19).

Thus at 31 May 2010 it is unlikely that the entity would generate taxable profits before the unused tax losses expired. The improved performance in 2010 would not be indicative of future good performance as Cate would have suffered a net loss before tax had it not been for the non-operating gains.

Cate's anticipation of improved future trading could not alone be regarded as meeting the requirement for strong evidence of future profits. When assessing the use of carry-forward tax losses, weight should be given to revenues from existing orders or confirmed contracts rather than those that are merely expected from improved trading. Thus the recognition of deferred tax assets on losses carried forward is not in accordance with FRS 19 as Cate is not able to provide convincing evidence that sufficient taxable profits would be generated against which the unused tax losses could be offset.

(b) Investment

Cate's position for an investment where the investor has significant influence and its method of calculating fair value can be challenged.

An asset's recoverable amount represents its greatest value to the business in terms of its cash flows that it can generate i.e. the higher of net realisable value (which is what the asset can be sold for less direct selling expenses) and value in use (the cash flows that are expected to be generated from its continued use including those from its ultimate disposal). The assets recoverable amount is compared with its carrying value to indicate any impairment. Both net realisable value and value in use

can be difficult to determine. However, it is not always necessary to calculate both measures, as if the NRV or value in use is greater than the carrying amount, there is no need to estimate the other amount.

It should be possible in this case to calculate a figure for the recoverable amount. Cate's view that market price cannot reflect the fair value of significant holdings of equity such as an investment in an associate is incorrect as FRS 11 'Impairment of fixed assets and goodwill' prescribes the method of conducting the impairment test in such circumstances by stating that if there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal. Further, the appropriate market price is usually the current bid price.

Additionally investments in associates generate discrete cash flows and should be considered individually. Their value in use should normally be based on the future cash flows of the underlying entities that are attributable to the group's interest rather than on the dividend cash flows. Investments in associates come within the scope of FRS 11. Estimates of future cash flows should be produced. These cash flows are then discounted to present value hence giving value in use.

It seems as though Cate wishes to avoid an impairment charge on the investment.

(c) FRS 3 'Reporting Financial Performance'

An undertaking will cease to be a subsidiary when a group sells or reduces its percentage interest in the undertaking below 50%. Similarly a parent may lose control because of changes in the rights it holds or those held by another party in that undertaking. A reduction in the percentage interest may arise from a direct disposal or from an indirect disposal, for example the exercise of share options by another party or the subsidiary issues shares to other non-group parties as in the case of Cate. A gain or loss will normally arise in both cases. A partial disposal of an interest in a subsidiary in which the parent company loses control but retains an interest as an associate or trade investment creates the recognition of a gain or loss on the interest disposed of. The profit or loss should be calculated as the difference between the carrying amount of the net assets of the subsidiary attributable to the group's interest before the reduction and the carrying amount of the net assets of the subsidiary attributable to the group's interest after the reduction including any proceeds received. The net assets include any related goodwill not written off. In this case, Cate should stop consolidating Date on a line-by-line basis from the date that control was lost. Further investigation is required into whether the holding is treated as an associate or trade investment. The agreement that Cate is no longer represented on the board or able to participate in management would suggest loss of significant influence despite the 35% of voting rights retained.

FRS 3 requires the profit or loss on sale of an asset to be calculated by reference to the carrying value of that asset and conflicts with FRS 2 calculation above as goodwill is used in the calculation. Also the important components, which FRS 3 requires to be highlighted, are:

(a) the results of continuing operations (separately highlighting the results of acquisitions in the year, if material);
(b) the results of discontinued operations;
(c) the results of exceptional transactions – analysed over continuing and discontinued operations.

FRS 3 defines a discontinued operation as an operation that is sold or terminated and that satisfies all of the following conditions:

(a) the sale or termination is completed either in the period or before the earlier of three months after the commencement of the subsequent period or the date on which the financial statements are approved;
(b) if a termination, the former activities have ceased permanently;
(c) the sale or termination has a material effect on the nature and focus of the reporting entity's operations and represents a material reduction in its operating facilities resulting either from its withdrawal from a particular market (whether class of business or geographical) or from a material reduction in turnover in continuing markets;
(d) the assets, liabilities, results of operations and activities are clearly distinguishable, physically and operationally and for financial reporting purposes.

Cate has not met all of the conditions of FRS 3 but it could be argued that the best presentation in the financial statements is that set out in FRS 3 for the following reasons.

The decision not to subscribe to the issue of new shares of Date is clearly a change in the strategy of Cate. Further by deciding not to subscribe to the issue of new shares of Date, Cate agreed to the dilution and the loss of control, which could be argued, is similar to a decision to sell shares while retaining a continuing interest in the entity. Also Date represents a separate distinguishable line of business, which is a determining factor in FRS 3, and information disclosed on FRS 3 principles highlights the impact of Date on Cate's financial statements. Finally, the agreement between Date's shareholders confirms that Cate has lost control over its former subsidiary.

The results of Date should be classified as discontinued if the retained interest is not being subject to significant influence by the group.

(d) Defined benefit plan

The Plan is not a defined contribution plan because Cate has a legal or constructive obligation to pay further contributions if the fund does not have sufficient assets to pay all employee benefits relating to employee service in the current and prior periods (FRS 17 Para's 2, 20). All other post-employment benefit plans that do not qualify as a defined contribution plan are, by definition therefore defined benefit plans. Defined benefit plans may be unfunded, or they may be wholly or partly funded. Also FRS 17 indicates that Cate's plan is a defined benefit plan as it shows that an entity's obligation is not limited to the amount that it agrees to contribute to the fund. An example of a constructive obligation is a practice of granting annual increases

to pensions in payment and deferred pensions that are discretionary but are in practice granted as a measure of protection against inflation. The cost of the increases should be factored into the annual service cost and scheme liability. According to the terms of the Plan, if Cate opts to terminate, Cate is responsible for discharging the liability created by the Plan. FRS 17 says that an entity should account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the enterprise's informal practices. Informal practices give rise to a constructive obligation where the enterprise has no realistic alternative but to pay employee benefits. Even if the Plan were not considered to be a defined benefit plan under FRS 17, Cate would have a constructive obligation to provide the benefit, having a history of paying benefits. The practice has created a valid expectation on the part of employees that the amounts will be paid in the future. Therefore Cate should account for the Plan as a defined benefit plan in accordance with FRS 17. Cate has to recognise, at a minimum, its net present liability for the benefits to be paid under the Plan.

3 Financial Instruments

(a) FRS 26 Financial Instruments 'Recognition and measurement' states that derivative is a financial instrument:

(i) Whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index; such as the price of edible oil;
(ii) That requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; in the case of the future purchase of oil, the initial investment is nil; and
(iii) That is settled at a future date.

However, when a contract's purpose is to take physical delivery in the normal course of business, then normally the contract is not considered to be a derivative contract, unless the entity has a practice of settling the contracts on a net basis. In this case the contracts will be considered to be derivative contracts and should be accounted for at fair value through profit and loss. Even though the entity sometimes takes physical delivery, the entity has a practice of settling similar contracts on a net basis and taking delivery, only to sell shortly afterwards. Hedge accounting techniques may be used if the conditions in FRS 26 are met.

FRS 26 permits hedge accounting under certain circumstances provided that the hedging relationship is: formally designated and documented, including the entity's risk management objective and strategy for undertaking the hedge, identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness; and expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk as designated and documented, and the effectiveness can be reliably measured.

Seltec would use cash flow or fair value hedge accounting. A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or a previously unrecognised firm commitment to buy or sell an asset at a fixed price or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. The gain or loss from the change in fair value of the hedging instrument is recognised immediately in profit or loss. At the same time the carrying amount of the hedged item is adjusted for the corresponding gain or loss with respect to the hedged risk, which is also recognised immediately in net profit or loss.

A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss [FRS 26]. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity and reclassified to the profit and loss account when the hedged cash transaction affects profit or loss [FRS 26].

FRS 26 is restrictive because of the difficulty of isolating and measuring the cash flows attributable to the specific risks for the non-financial items. Assuming all of the documentation criteria are met, Seltec can use hedge accounting but may favour a fair value hedge in order to reduce earnings volatility. All price changes of the edible oil will be taken into account including its type and geographical location and compared with changes in the value of the future. If the contracts have different price elements, then ineffectiveness will occur. Hedge accounting can be applied as long as the ineffectiveness is not outside the range 80%–125%.

FRS 26 defines an embedded derivative as a component of a hybrid instrument that also includes a non-derivative host contract, with the effect that some of the cash flows of the instrument vary in a way similar to a stand-alone derivative. As derivatives must be accounted for at fair value in the balance sheet with changes recognised in the profit or loss, so must some embedded derivatives. FRS 26 requires that an embedded derivative should be separated from its host contract and accounted for as a derivative when:

(i) the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract;
(ii) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
(iii) the entire instrument is not measured at fair value with changes in fair value recognised in profit or loss.

If an embedded derivative is separated, the host contract is accounted for under the appropriate standard. A foreign currency denominated contract contains an embedded derivative unless it meets one of the following criteria:

(i) the foreign currency denominated in the contract is that of either party to the contract,
(ii) the currency of the contract is that in which the related good or service is routinely denominated in commercial transactions,
(iii) the currency is that commonly used in such contracts in the market in which the transaction takes place.

In this case the dollar is not the functional currency of either party, oil is not routinely denominated in dollars but euro as most of Seltec's trade as regards the oil appears to be in the euro and the currency is not that normally used in business transactions in the environment in which Seltec carries out its business. Additionally, the economic risks are not closely related as currency fluctuations and changes in the price of oil have different risks. The host contract is not measured at fair value but would meet the definition of a derivative if it were a separate instrument with the same terms. The currency derivative should therefore be accounted for at fair value through profit or loss.

(b) Intangible assets and purchase of entities

FRS 10 states that where intangible assets are regarded as having limited useful economic lives, they should be amortised on a systematic basis over those lives.

Where intangible assets are regarded as having indefinite useful economic lives, they should not be amortised.

A life of more than 20 years, or an indefinite life, may only be taken if:

(a) the durability of the intangible asset can be demonstrated and justifies estimating the useful economic life to exceed 20 years;
(b) the goodwill or intangible asset is capable of continued measurement (so that annual impairment reviews will be feasible).

The useful life of an intangible asset is defined in FRS 10 as 'the period over which the entity expects to derive economic benefits from that asset'.

Factors that should be considered are:

(i) The nature of the business and the stability of the industry as well as the entity's commitment to support the brand
(ii) The extent to which the brand has long-term potential that is not underpinned by short-term fashion or trends. That is, the brand has had a period of proven success
(iii) The extent to which the products carrying the brand are resistant to changes in the operating environment. These products should be resistant to changes in legal, technological and competitive environments.

These factors combine to present an overall picture of the durability of the brand. The brand of oil, which has been in existence for many years, could be said to have an indefinite life as it has already proven its longevity having been successful for many years. FRS 10 requires that the useful life be reviewed at the end of each reporting period and revised if necessary. Its useful life should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate. There should be an impairment review at the end of each reporting period.

However, the oil named after a famous film star is likely to decline in popularity as the popularity of the film star declines. It is a new product and its longevity has not been proven and therefore it is likely to have a finite life. The cost less residual value of an intangible asset with a finite useful life should be amortised on a systematic basis over that life. The amortisation method should reflect the expected pattern of depletion but a straight-line method should be chosen unless another method can be demonstrated to be more appropriate.

A business combination is a transaction or event in which an acquirer obtains control of one or more undertakings. An undertaking is defined as a 'body corporate, partnership or an unincorporated association carrying on a trade or business with or without a view to profit'. The two entitles do not meet the definition of an undertaking in FRS 2 'Accounting for Subsidiary Undertakings' as they are not carrying on a trade such as real estate management which are applied to the retail space that they own. The entities do not generate any outputs such as rental income. Therefore the acquisition should be treated as a purchase of assets.

4 (a) (i) The existing accounting model for leases has been criticised for failing to meet the needs of users of financial statements. It can be argued that operating leases give rise to assets and liabilities that should be recognised in the financial statements of lessees. Consequently, users may adjust the amounts recognised in financial statements in an attempt to recognise those assets and liabilities and reflect the effect of lease contracts in profit or loss. The information available to users in the notes to the financial statements is often insufficient to make reliable adjustments to the financial statements.

The existence of two different accounting methods for finance leases and operating leases means that similar transactions can be accounted for very differently. This affects the comparability of financial statements. Also current accounting standards provide opportunities to structure transactions so as to achieve a specific lease classification. If the lease is classified as an operating lease, the lessee obtains a source of financing that can be difficult for users to understand, as it is not recognised in the financial statements.

Existing accounting methods have been criticised for their complexity. In particular, it has proved difficult to define the dividing line between the principles relating to finance and operating leases. As a result, standards use a mixture of subjective judgments and rule based criteria that can be difficult to apply.

The existing accounting model can be said to be conceptually flawed. On entering an operating lease contract, the lessee obtains a valuable right to use the leased item. This right meets the Statements of Principle's definition of an asset. Additionally the lessee assumes an obligation to pay rentals that meet the Statements of Principle's definition of a liability. However, if the lessee classifies the lease as an operating lease, that right and obligation are not recognised.

There are significant and growing differences between the accounting methods for leases and other contractual arrangements. This has led to inconsistent accounting for arrangements that meet the definition of a lease and similar arrangements that do not. For example leases are financial instruments but they are scoped out of FRS 25/26.

(ii) An asset is a right or other access to future economic benefits controlled by an entity as a result of past transactions or events. Holcombe has the right to use the leased plant as an economic resource because the entity can use it to generate cash inflows or reduce cash outflows. Similarly, Holcombe controls the right to use the leased item during the lease term because the lessor is unable to recover or have access to the resource without the consent of the lessee or unless there is a breach of contract. The control results from past events, which is the signing of the lease contract and the receipt of the plant by the lessee. Holcombe also maintains the asset.

Unless the lessee breaches the contract, Holcombe has an unconditional right to use the leased item. Future economic benefits will flow to the lessee from the use of the leased item during the lease term. Thus it could be concluded that the lessee's right to use a leased item for the lease term meets the definitions of an asset in the Statement of Principles.

A liability is an obligation to transfer economic benefits as a result of past transactions or events. The obligation to pay rentals is a liability. Unless Holcombe breaches the contract, the lessor has no contractual right to take possession of the item until the end of the lease term. Equally, the entity has no contractual right to terminate the lease and avoid paying rentals. Therefore, the lessee has an unconditional obligation to pay rentals. Thus the entity has a present obligation to pay rentals which arises out of a past event, which is the signing of the lease contract and the receipt of the item by the lessee. Finally the obligation is expected to result in an outflow of economic benefits in the form of cash.

Thus the entity's obligation to pay rentals meets the definition of a liability in the Statements of Principles.

(b) (i) On sale of the building Holcombe will recognise the following in the financial statements to 30 April 2010:

Dr Cash €150m
Cr Office building €120m
Cr Deferred Income (B/S) €30m
Recognition of gain on the sale of the building

Dr Deferred Income (B/S) €6m
Cr Deferred Income (P&L) €6m
Release of the gain on sale of the building ($30m/5 years)

Dr Operating lease asset €63·89m
Cr Obligation to pay rentals €63·89m
Recognition of the leaseback at net present value of lease payments using 8% discount rate

In the first year of the leaseback, Holcombe will recognise the following:

Dr Lease obligation – rentals €16m
Cr Cash €16m
Recognition of payment of rentals

Dr Interest expense €5·11m
Cr Lease obligation €5·11m
Recognition of interest expense (€63·89m x 8%)

Dr Depreciation expense €12·78m
Cr Right-of-use asset €12·78m
Recognition of depreciation of operating lease asset over five years (€63·89m/5 years). The balance sheet will show a carrying value of €51·11m being cost of €63·89m less depreciation of €12·78m.

An alternative to the above is to leave the carrying amount of the asset unchanged and the proceeds are effectively treated as a creditor. This is not referred to in SSAP 21 but is suggested as an alternative in para 155 of the guidance notes to the standard. The justification of this treatment is that the substance of the transaction is the raising of finance and there is no reason why the asset value should be changed. Payments under the terms of the lease should be split between capital and finance charge. The finance charge should be charged to the profit and loss account and the capital part deducted from the creditor figure.

(ii) Inflation adjustments should be recognised in the period in which they are incurred as they are effectively contingent rent and are not included in any minimum lease calculations. The amount would be recognised when a present obligation exists that will require a transfer of economic benefits. Thus in this case, Holcombe would recognise operating rentals of €5 million in year 1, €5 million in year 2 plus the inflation adjustment at the beginning of year 2, and €5 million in year 3 plus the inflation adjustment at the beginning of year 2 plus inflation adjustment at the beginning of year 3. Based on current inflation, the rent will be €5·2 million in year 2 and €5·408 million in year 3.

				Marks
1	**(a)**		Consolidated Profit and loss account	5
			Bochem	8
			Ceram	6
			Stock	2
			Bond	4
			PPE	3
			Impairment of customer	2
			Employee benefits	2
			MI	3
				35
	(b)		Amendments to FRS 26/FRS 29	4
			Management of earnings	3
	(c)		Description of management of earnings	3
			Moral/ethical considerations	3
			Professional marks	2
				50
2			Deferred tax	5
			Investment in associate	5
			FRS 3 Discussion and conclusion	8
			FRS 17 Discussion and conclusion	5
			Professional marks	2
				25
3			Hedge accounting	5
			Futures	5
			Embedded derivative	4
			Brands	5
			Business combinations	4
			Professional marks	2
				25
4	**(a)**	**(i)**	Subjective	7
		(ii)	Subjective	7
			Professional marks	2
	(b)	**(i)**	Recognition of gain	1
			Recognition of the leaseback	1
			Recognition of payment of rentals	2
			Recognition of interest expense and depreciation	2
		(ii)	Contingent rentals	3
				25