Answers

1 (a) Consolidated Balance Sheet of Hilda as at 31 March 2003:

Assets	$ million	$ million
Non-current assets		
Property, plant and equipment (300 + 293)		593
Goodwill	75	
Consolidated negative goodwill (w (ii))	(37)	38
Investments at market value (60 + 30 – 20)		70
		701
Current assets		
Inventory (56 + 44)	100	
Accounts receivable (64 + 29)	93	
Bank	14	207
Total assets		908
Equity and liabilities		
Capital and reserves:		
Ordinary shares $1 each		50
Share premium	50	
Accumulated profits (w (i))	135	185
		235
Non-current liabilities		
Provision for restructuring (w (iv))	40	
10% loan note (100 + 10 accrued interest)	110	
Deferred consideration (99 + 10 unwinding of discount)	109	
Minority interest (w (iii))	62	321
Current liabilities		
Accounts payable (175 + 75)	250	
Overdraft	16	
Taxation (61 + 25)	86	352
Total equity and liabilities		908

Workings (Note: all figures in $ million)

(i) **Accumulated profits**

	Hilda	Sybil		Hilda	Sybil
Loss on investments (90 – 70)		20	B/f	163	180
Loan interest and unwinding of discount (10 + 10)	20		Post acq loss	(20)	
Minority interest (20% x 160)		32	Realisation of negative goodwill (w (ii))	12	
Pre acq profit (80% x 185)		148			
Post acq loss (80% x ((185 – 180) + 20))		(20)			
Balance c/f	135				
	155	180		155	180

(ii) **Cost of control**

Cash consideration (100 x 80% x $1·50)	120	Ordinary shares (80% x 100)	80
Deferred consideration (120 x 0·825)	99	Share premium (80% x 40)	32
	219	Pre acq profit (w (i))	148
Negative goodwill	49	Fair value adjustment (w (iv))	8
	268		268

The contingent consideration has been discounted at the company's cost of capital for two years.
The negative goodwill of $49 million is attributable to:

	$ million
estimated losses	9
non-monetary assets (balance)	40
negative goodwill	49

In the year to 31 March 2003 $4 million of the $9 million negative goodwill attributable to losses can be realised. This is based on the group share (80%) of Sybil's operating loss of $5 million (185 – 180). The negative goodwill attributable to the non-monetary assets of $40 million will be realised at $8 million per annum based on a five year life. This means a total of $12 million (4 + 8) will be included in the income statement (and therefore in accumulated profits) and the balance of $37 million (5 + 32) is shown as negative goodwill in the balance sheet.

(iii) **Minority interest**

		Ordinary shares (20% x 100)	20
		Share premium (20% x 40)	8
		Accumulated profits (w (i))	32
Blance c/f	62	Fair value adjustment (w (iv))	2
	62		62

(iv) **Fair value adjustment**

Restructing provision (see below)	20	Investments (90 – 60)	30
Group 80%	8		
Minority 20%	2		
	30		30

Note: the amount of $3 million for staff retraining included in the restructuring provision is not a recognisable category of expense under IAS 37 'Provisions, Contingent Liabilities and, Contingent Assets' and IAS 22 'Business Combinations'. Therefore only $40 million can be recognised, of which $20 million has already been provided for leaving a fair value adjustment of $20 million.

(b) Negative goodwill arises where the cost of an acquisition is less than the acquirer's interest in the fair values of the identifiable net assets at the date of acquisition. Intuitively it does not make sense for the owners of a company to sell the company's net assets for less than they are worth. This view is reflected by the IASB as they appear rather sceptical about the existence of negative goodwill. They say the apparent existence of negative goodwill may indicate that identifiable assets have been overvalued or some identifiable liabilities have been omitted. Consequently a careful check of the value of the assets acquired and whether any liabilities have been omitted is required.

Negative goodwill may arise for several reasons; the most obvious is that there has been a bargain purchase. This may occur because the vendor is in a poor financial position and needs to realise assets quickly, or it may be due to good negotiating skills on the part of the acquirer, or that the vendor does not realise how much the assets are really worth.

Alternatively negative goodwill may arise where a company, in determining the amount of consideration it is willing to pay for a business, will take into account the cost of post acquisition reorganisation expenditure and future operating losses that it believes will occur. The effect of this is that the acquirer will reduce the consideration offered/paid. In most circumstances these reorganisation costs and expected operating losses do not qualify as identifiable liabilities at the date of acquisition and this leads to the consideration being lower than the identifiable net assets. It seems ironic that the IASB cautions against omitting liabilities at the date of acquisition, but does not allow reorganisation costs and future losses to be treated as liabilities. To acquisitive managers, these costs are very real and have to be taken into account when determining an offer price.

Accounting treatment of negative goodwill:

IAS 22 'Business Combinations' requires the accounting treatment of negative goodwill to reflect its nature. To the extent that it represents reorganisation expenses and expected future operating losses that were not allowed to be recognised as liabilities at the time of the acquisition, this amount should be released to the income statement as these expenses and losses arise. Any remaining negative goodwill (which would include any amount attributable to the previous expenses and losses that did not arise) up to the value of the acquired non-monetary assets should be released to income over the weighted average useful lives of the acquired depreciable non-monetary assets. Any negative goodwill in excess of these amounts (which should be very rare) is effectively attributable to the acquired monetary assets and this should be recognised in income immediately.

Unamortised negative goodwill should be shown as a deduction from the assets of the reporting company under the heading of goodwill.

2 (a) Beachwood – Income Statement – Year to 31 March 2003

	$000 Continuing	$000	$ 000 Discontinuing	$000 Total
Sales revenue	12,980		2,120	15,100
Cost of sales (w (i))	(6,800)		(1,970)	(8,770)
Gross profit	6,180		150	6,330
Operating expenses	(590)		(250)	(840)
Loss on sale of net assets of discontinued operation		500		
less tax relief		(150)	(350)	(350)
	5,590		(450)	5,140
Finance costs (w (ii))				(420)
Investment income				200
Exchange loss (w (iii))				(50)
Gain on investment property				160
Profit before tax				5,030
Income tax (w (iv))				(1,330)
Net profit from ordinary activities for the period				3,700

Note: IAS 35 'Discontinuing Operations' is not specific as to how information on discontinued operations is to be shown, although it does require the loss and related tax effects of the sale of net assets to be disclosed on the face of the income statement. Therefore other methods of disclosure would be acceptable.

(b) Beachwood – Statement of Changes in Equity – Year to 31 March 2003

	Ordinary Shares $000	Accumulated profits $000	Total $000
Balance at 1 April 2002	12,500	5,170	17,670
Net profit for the period		3,700	3,700
Dividends paid (680 - 180)		(500)	(500)
Dividends declared (12,500 x 5 x 2 cents)		(1,250)	(1,250)
Balance at 31 March 2003	12,500	7,120	19,620

(c) Beachwood – Balance Sheet as at 31 March 2003

	$000	$000
Non-current assets		
Investment property (3,000 + 160)		3,160
Property, plant and equipment (w (v))		25,200
		28,360
Current Assets		
Inventory	650	
Trade receivables (2,200 – 50 (w (iii)))	2,150	
Bank	420	3,220
Total assets		31,580
Total equity and liabilities:		
Ordinary shares of 20 cents each		12,500
Reserves:		
Accumulated profits (see (b))		7,120
		19,620
Non-current liabilities		
6% Redeemable preference shares $1 each	6,000	
Provision for decommissioning costs (750 + 60 (w (ii)) and (v)))	810	
Deferred tax (920 + 220)	1,140	7,950
Current liabilities (w (vi))		4,010
Total equity and liabilities		31,580

Workings

(i) Cost of sales:

	$000
From question	8,570
Depreciation of chemical plant (w (v))	200
	8,770

(ii) Finance costs:

	$000
Preference shares	360
Decommissioning provision	60
	420

Redeemable preference shares have the substance of debt and should be treated as such. The total dividends of $360,000 ($180,000 paid + $180,000 accrued) should be treated as a finance cost.

The provision for decommissioning cost must be unwound over the life of the chemical plant and treated as a finance cost. It was discounted at 8%, thus this would give a finance cost of $60,000 ($750,000 x 8%).

(iii) Monetary assets denominated in a foreign currency must be translated at the closing rate of exchange. A receivable of $300,000 translated at an exchange rate of $1 = €1·50 would represent an amount outstanding of €450,000. When this is retranslated at $1 = €1·80 this gives a receivable of $250,000. Thus there is an exchange loss of $50,000.

(iv) Income tax:

	$000
Provision for current period	900
Under provision in previous year	210
Deferred tax provision	220
	1,330

(v) Non-current assets

Chemical plant:
Applying the requirements of IAS 37 would mean that the compulsory decommissioning costs are a liability that must be provided for. A rather controversial aspect of this requirement is that the debit of the provision is added to the cost of the asset. Thus the depreciation of the chemical plant would be $200,000 (($1,250 + $750)/10 years).

Summarising:	$000
Leasehold buildings	17,800
Plant and equipment	5,600
Chemical plant (1,250 + 750 - 200)	1,800
	25,200

(vi) Current liabilities:

	$000
Trade payables	1,680
Income tax	900
Declared ordinary dividend (see (b))	1,250
Finance costs (re preference shares (w (ii)))	180
	4,010

3 (a) (i) Although a related party relationship may seem irrelevant if no related party transactions have occurred, this is not the case. It may be that if Motorworld is part of a well-respected group, this encourages other companies to treat the company more favourably than if the company were not part of such a group. Thus Motorworld may obtain custom, receive favourable credit ratings, and benefit from a superior management team simply by being a part of the Prestige Group. Indeed many companies take advantage of such a situation by 'advertising' on their product packaging and other material that they are part of (say) the Prestige Group. If Motorworld was purchased, it would no longer be a part of the Prestige Group and this may lead to a reduction in sales, credit lines etc. Given the inherent difficulty in determining the effect of these influences, no disclosure is required.

(ii) Where related party transactions have occurred, but they are conducted under normal commercial terms, there may seem little cause for concern. Once again this is not the case. It may be that but for the related party relationships the transactions would not have occurred at all. For example, the directors of the Prestige Group may have instructed all members of the group to buy their motor vehicle requirements from Motorworld. This would be a normal commercial decision, as it would keep any profit on such trading within the group rather than it going to an external party. However, if Motorworld were to be purchased on the basis of its reported results, any prospective purchaser would have to be aware that the intra-group trading that Motorworld may have benefited from may no longer arise once Motorworld ceases to be part of the Prestige Group.

(iii) Where related party transactions have occurred that are not at 'arms length' (normal commercial terms), this represents the obvious danger that the financial statements may have been manipulated for a specific purpose. The favourable aspect could apply either to Motorworld (i.e. Motorworld's financial statements are improved) or Motorworld's interest could have been subordinated to other members of the group. IAS 24 lists, amongst other items, purchase and sales of goods and other assets, agency, licensing and leasing arrangements, provision of finance and guarantees and collateral. Taking these as indicative means there is hardly an area of financial reporting that could not be affected by related party transactions. Most obvious would be the possible manipulation of profitability, taxation expense, liquidity ratios and gearing. IAS 24 requires the reporting entity to disclose the nature of the related party relationships as well as the types of transactions and the elements of the transactions that are necessary for an understanding of the financial statements. Thus in assessing the performance of Motorworld, a prospective purchaser would need to study carefully the disclosures required by IAS 24.

It should be added that in many jurisdictions, the members of a group do not have a completely free choice of pricing policies. There are often strict rules (usually originating from taxation authorities) over the setting, for example, of transfer prices.

(b) (i) For many years there has been a fairly even debate as to whether borrowing costs should or should not be capitalised. Arguments in favour of capitalisation are:

Borrowing costs are in principle no different to other costs that do qualify for capitalisation, thus capitalisation is consistent with the treatment of other costs.

The accrual/matching concept intends that income generated in a period should be matched with the costs incurred in earning that income. Capitalisation of borrowing costs achieves this, as the depreciation of an asset would include a proportion of the borrowing cost.

It has been argued that for companies that construct their own assets, the inclusion of borrowing costs, gives a more consistent basis for comparison with those companies that choose to buy their assets. This is based on the presumption that the manufacturer of an asset would include interest as part of the costs it is trying to recover within the selling price.

Arguments against capitalisation are:
Interest is the cost of borrowing money over time and should be charged to the period to which it relates rather than a future period.

It can create inconsistency. The same type of asset can have different costs depending upon the method of finance.

In practice it is not always possible to determine how an asset has been financed. This is specifically true where an asset is financed from 'general' borrowings rather than specific borrowings. There is also the issue of whether 'notional' borrowings should be capitalised.

Even where capitalisation of interest is permitted, it must cease when the asset is completed and ready for use. However the financing cost of an asset continues over its life. This again creates inconsistency.

It is believed to be more prudent.
In summary there are both valid arguments for and against capitalisation, It seems the IASB, in making non-capitalisation the benchmark treatment, comes down in favour of the arguments against, but in having an allowed alternative, it does not rule it out altogether.

(ii) The amount capitalised at the end of the year of \$12 million would give an average carrying amount of \$6 million (\$12 million/2) throughout the year (based on an even expenditure through the year).

The cost of borrowing should be based on the weighted average cost of the funds used specifically to finance similar projects:

$$\frac{(\$2 \text{ million x } 15\%) + (\$3 \text{ million x } 8\%) + (\$5 \text{ million x } 10\%)}{(\$2 \text{ million} + \$3 \text{ million} + \$5 \text{ million})} = 10{\cdot}4\%$$

IAS 23 says capitalisation should be suspended during an extended period of interruption of development. However this does not apply to a necessary temporary delay. Although judgment is needed to interpret this requirement, it would seem that the two-week delay is a necessary delay, but the two month delay would seem to be a period where capitalisation should be suspended. Thus the period of capitalisation is 10 months.

This gives a calculation of:
\$6 million x 10·4% x 10/12 = \$520,000.

4 (a) (i) The disclosure of a company's basic eps is thought to give a more reliable measure of the trend of a company's profits than the trend shown by the profits themselves. This is because the eps takes into account (in the denominator) any extra investment in the company's equity shares that would be expected to lead to higher earnings. A comparison of absolute profits has no 'correction' for any additional investment that may have generated additional earnings. Thus it would be quite possible for a company's profits to show an increasing trend and its eps to show a decreasing trend. In these circumstances the trend of eps is a more reliable measure of performance. It is worth noting that a comparison of two companies' eps is not meaningful i.e. if two companies' eps are the same, it does not mean they are performing equally. This is because the eps takes no account of each company's share price. This problem can be corrected by calculating and comparing each company's PE ratio (market price/eps).

(ii) The diluted eps effectively acts as a warning to shareholders. Circumstances may exist where certain providers of finance (other than existing ordinary shareholders) or holders of share options may become ordinary shareholders in the future (e.g. holders of convertible debt or directors share options). When or if these circumstances 'crystallise', the company's earnings may be spread over a greater number of shares thus diluting the eps. The diluted calculation is forward looking whereas the basic eps could be said to be backward looking. Because of the forward looking aspect of the diluted eps figure, the test for dilution is based on the profit from continuing ordinary operations (after deducting any preference dividends) and excludes the effects of any extraordinary items. IAS 33 requires only truly dilutive circumstances to be included in the calculation; any potential anti-dilutive conversions (which would increase the eps) are ignored. It should be stressed that although the test for dilution is based on the continuing ordinary operations, the actual calculation of the diluted eps is based upon the earnings used for the basic eps calculation. The diluted eps is not a forecast of future eps. It is the current eps adjusted for a future capital base that may or may not occur.

(b) **Bovine – basic eps** (Note: money amounts in $000, shares expressed in thousands)

Profit after tax and extraordinary items (1,150 - 120)		1,030
Deduct preference dividends – 6% non-redeemable shares ($500 x 6%)	(30)	
– 10% convertible shares (1,000 x 10%)	(100)	(130)
		900
Number of shares (1·8 million x 4)		7,200
EPS (900/7,200 x 100)		12·5 cents

Diluted eps:

In order to determine if a potential conversion is dilutive each circumstance has to be ranked in order of its dilutive effect:

	Increase in number of shares		increase in earnings	earnings per incremental share
Options (w (i))	1,200		nil	nil
10% convertible preference shares ((1,000/5) x 3)	600	(1,000 x 10%)	100	16.7 cents
8% convertible loan stock (1,500/100 x 120)	1,800	(1,500 x 8% x 75%)	90	5.0 cents

The results of the above are that the directors' options are the most dilutive, then the loan stock and finally the preference shares.

Determining the potential shares to be included in the dilution calculation:

	control earnings	Ordinary Shares	eps
ordinary shares in issue	1,300	7,200	18·1 cents
bonus element of directors options (w (i))	nil	1,200	
	1,300	8,400	15·5 cents dilutive
8% convertible loan stock	90	1,800	
	1,390	10,200	13·6 cents dilutive
10% convertible preference shares	100	600	
	1,490	10,800	13·8 cents antidilutive

The diluted eps is calculated as:

Net profit (900 as above + 90 re 8% convertible loan stock)	990
Number of shares (7,200 + 1,200 + 1,800)	10,200
Diluted eps	9·7 cents

Working

(i) The exercise of the directors' option would yield proceeds of $5·6 million (4 million x $1·40)
This would be sufficient to purchase 2·8 million shares at the full market price ($5·6 million/$2 each).
Thus the bonus or 'free' number of shares is 1·2 million (4·0 million – 2·8 million).

5 (a) Identity of those charged with governance and matters to be communicated

Identity

(i) 'Governance' is described in ISA 260 as relating to those entrusted with the overall supervision, control and direction of an entity. Such people are usually accountable for ensuring that an entity achieves its objectives, for financial reporting and for reporting to interested parties.

(ii) Executive management may or may not be charged with governance. Increasingly, non-executive directors, audit committees or supervisory boards take responsibility for such matters. In some countries there are unitary boards, in others the responsibility is divided.

(iii) It is for the auditor to decide who, in fact, is charged with governance in a particular entity; the legal status and responsibilities of relevant persons or committees is relevant to this decision. It is helpful if the engagement letter identifies to whom matters are to be reported, when, and the nature of matters to be reported.

Nature of matters to be reported

Matters of governance interest are those that arise from the audit of the financial statements and which are, in the opinion of the auditor, both important and relevant to those charged with governance. Auditors are not required to search separately for such matters. These include matters relating to:

(iv) The general approach and overall scope (and any limitations) of the audit.

(v) The selection of or significant changes in accounting policies that could have a material effect on the financial statements.

(vi) The potential effect of significant risk exposures, such as pending litigation, that may require disclosure.

(vii) Audit adjustments that could have a significant effect on the financial statements.

(viii) Material uncertainties relating to the going concern status of the entity.

(ix) Disagreements with executive management about matters that might materially affect the financial statements.

(x) Expected modifications to the audit report.

(xi) Material weaknesses in the structure or operation of internal control systems.

(xii) Questions regarding management integrity and fraud involving management (legal advice should probably be sought first on such matters).

(b) Issues where senior management lacks integrity or may be engaging in illegal activities.

(i) Where senior management appears to lack integrity, as a result of aggressive earnings management, for example, auditors need to consider the quality, nature and extent of audit evidence obtained, particularly where the matters involved are heavily dependent on management judgement.

(ii) Such situations are difficult because where management lacks integrity, it is common for auditors to be pressurised into signing audit reports with the threat that auditors will delay or destroy significant business transactions if they fail to do so. It is not uncommon for auditors to be presented with significant adjustments to the financial statements late, in an attempt at preventing the proper audit of such figures.

(iii) Where senior management lacks integrity, ISA 260 suggests that the matter be reported to those charged with governance. Clearly this is not possible if those that lack integrity are those charged with governance. Even if those charged with governance are not involved, it may be very difficult for auditors to 'accuse' senior management of a lack of integrity without the risk of irrevocable damage to the client-auditor relationship or even of the threat of litigation for slander or libel.

(iv) Legislation in many countries, and ACCA's 'Rules of Professional Conduct', permit or require auditors to report suspicions of negligence or recklessness, or illegal activities such as money laundering, to the appropriate authorities. This is particularly the case in the financial services sector. Authorities may include regulatory bodies (such as stock exchanges or bodies supervising banking activities, for example), or bodies such as the police, serious fraud or tax authorities.

(v) Legislation and ACCA's 'Rules of Professional Conduct' normally protect auditors from litigation by the persons reported on in such cases in order to encourage appropriate reporting. Sometimes the client must be given the opportunity to make a report, sometimes auditors are required to make a report without informing the client.

(vi) Such situations are rarely clear-cut and significant difficulties may arise if auditors are required to sign an audit report at the same time as being required to report without informing the client, and where they are under an obligation not to report their suspicions to the client in order not to prejudice any subsequent investigation.

(vii) In such situations auditors have to weigh the public interest or national security issues against commercial and other interests, including the risk of being associated with a client whose officers are subsequently alleged, or proved, to have been involved in illegal activities.

(viii) In practice, auditors will not proceed with any degree of confidence in these areas without taking extensive legal advice.

6 **(a)** Risks to the firm and difficulties

(i) Large multinational companies are likely to change the risk profile of an audit firm of any size. In this case, the work offered is attractive to the extent that it represents an opportunity to consolidate the practice in the Americas, and in the oil and gas industries, however, there are risks associated with this.

(ii) Work in the Americas is likely to be costly as a result of the risks of litigation. This is particularly the case where extractive industries are concerned. The firm would clearly need to increase staffing, and specialist resource, in the relevant offices. This might well be both difficult and expensive as specialists can be hard to find as they are in demand, and specialist resource can be time consuming to develop.

(iii) Whilst the firm might like to consolidate its position in the oil and gas market, exposure to one particular sector may represent an increased risk to the firm as a whole.

(iv) There may be good logistical and other reasons for several different firms of auditors being involved in the audit of group companies, however, 'non-involvement' in the audit of groups of companies that are material to the group financial statements represents an increased risk to the firm and will involve a considerable amount of administration work in ensuring that the audit of other group companies has been performed to an acceptable standard as required by ISA 600 'Using the work of another auditor'. The firm would also need to be confident that the reason for the use of several different firms was legitimate and acceptable.

(v) The responsibility for the audit opinion on the consolidated financial statements will rest with the firm regardless of who actually performs the audit work but in the current climate firms are less willing than they once were to take this risk. A solution to this problem might be found in a proposal for the audit of all of the group companies worldwide (although this may not be acceptable, or practical), or for a joint audit to be performed.

(b) ISA 720

Other information often includes directors' reports (in relation to which there may be statutory reporting requirements), chairman's statements and financial and operational reviews.

(i) ISA 720 requires that the auditors read the other information to identify any material inconsistencies with the audited financial statements.

(ii) A material inconsistency exists where the other information contradicts information in the audited financial statements. Where such inconsistencies are identified, amendment to the other information is necessary, and if the entity refuses to make the amendment, the auditors should consider referring to the matter in an 'emphasis of matter' paragraph in the auditor's report.

(iii) Clearly, the auditors need to consult with management (and advise management to consider taking legal advice) where such situations arise, before considering making reference to the matter in the audit report. The auditors should also consider taking legal advice themselves.

(iv) Such references are very rare in practice, particularly for larger companies, and the auditors would have to question whether they wished to continue their relationship with a company that refused to make appropriate amendments. They would, as a minimum, need to communicate the matter to those charged with governance (in accordance with ISA 260 'Communication of audit matters with those charged with governance') in writing.

(v) The firm would have to consider whether it were competent to 'read' the sustainability information with a view to identifying material inconsistencies.

(vi) It might wish, in any case, to recruit appropriate staff to deal with the matter as sustainability reporting will continue to be relevant to large companies and the client might well wish to prepare a stand-alone sustainability report (on which the auditors might be required to report) in the future.

(vii) However, it seems unlikely that matters contained in a sustainability report would come into direct conflict with information in the financial statements and the firm may well have sufficient general experience to consider that it is competent to read the material, and to identify any potential inconsistencies should they arise.

7 **(a)** Revalued assets

IAS 16 'Property, Plant and Equipment' requires that where properties are carried at valuation, revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date (fair value is usually market value).

(i) ISA 620 'Using the work of an expert' requires that the auditors are satisfied with the independence and competence of valuers (who should be professionally qualified) before placing reliance on the work performed by them. It is possible that the company employs its own valuers, or that it employs third party valuers. The auditors need to be satisfied that the assumptions used by valuers are reasonable and in accordance with their knowledge of the business and they also need to perform a detailed review of the work performed, as they alone are responsible for the audit report.

(ii) The auditors need to form an opinion on the appropriateness of the frequency of valuations in the light of market conditions and their knowledge of the business, particularly, in this case, in the light of the downturn in the market. Valuations should be carried out every three to five years unless there is significant volatility in the market, in which case annual revaluations may be necessary.

(iii) The auditors will need to review the basis on which properties have been selected for revaluation ensuring that no 'bias' has been displayed in determining categories for revaluation in order to produce the best possible result. Where an item of property is revalued, the entire class to which the property belongs should be revalued to avoid 'cherry-picking'.

(iv) The auditors should ensure that appropriate entries have been made in the appropriate accounting periods – the revaluation surpluses and deficits should be dealt with in the revaluation reserve or income statement as required by IAS 16, as should the adjustment to the depreciation charge.

IAS 36 'Impairment of Assets' requires that the recoverable amount of assets should be estimated whenever there is an indication that the asset may be impaired and that impairment losses should be recognised where the carrying amount exceeds the recoverable amount.

(v) The auditors should ensure that the company assessed, at the balance sheet date, whether there was any indication that assets may be impaired, as required by IAS 36.

(vi) The downturn in the market may indicate impairment losses and the auditors should enquire both of the client, and externally, as to the extent of the downturn and assess the need for write-downs.

(vii) The recoverable amount is the higher of net selling price and value in use; value in use is the present value of estimated future cash flows relating to the asset.

(viii) The auditors should compare net selling price with value in use. They should ensure that the assumptions relating to selling price, and the relevant estimated cash future flows, are based on reasonable and supportable assumptions. Assumptions supporting cash flows should represent management's best estimate of the economic conditions that will exist over the remaining useful life of the assets concerned. Net selling price may be difficult to establish if the properties are specialised and the market is uncertain. The auditors may need to refer to the work of valuers, once again, and should also look to the experience of similar companies.

(ix) The auditors should ensure that appropriate entries have been made for impairment losses. Impairment losses should generally be recognised in the income statement for assets carried at depreciated historical cost and as a revaluation reserve decrease for assets carried at valuation.

(x) It may be appropriate to request management representations on the appropriateness of the frequency and basis of revaluations and impairment reviews.

(b) Depreciation charges

IAS 16 requires that the depreciable amount of an item of property should be allocated on a systematic basis over its useful life and that the useful life should be reviewed periodically. Changes in the estimated useful lives of assets do not amount to changes in accounting policies and the depreciation charge for current and future periods (rather than prior periods) should therefore be adjusted where expectations as to useful life are significantly different from previous estimates.

(i) It is always important to exercise professional scepticism and to form an opinion as to whether the ostensible reason for changes such as these are the real reasons. The amounts involved are material and as such disclosure of the changes in estimated useful lives and depreciation methods should be made, even though there is no formal change in accounting policy. Have the changes been made in order to compensate for any impairment losses that have adversely affected the income statement, for example?

(ii) The auditors should enquire as to the reasons for the change, assumptions supporting the reasons and documentary evidence supporting the assumptions. Have similar properties (carried at cost) been sold at a profit, for example? Have they been carried in the books at a fully depreciated amount for a considerable period? Does the company have, or does it intend to implement, a high quality maintenance program?

(iii) IAS 16 requires that the depreciation method applied to property should be reviewed periodically and if there has been a change in the expected pattern of economic benefits, the method should be changed to reflect the changed pattern. This also constitutes a change in an accounting estimate and the depreciation charge for current and future periods should be adjusted.

(iv) Chamoix is a manufacturing company and changes in the pattern of expected benefits may be supportable by reference to changes in manufacturing methods, or products, for example. The auditors should enquire as to the assumptions underlying the expected change in expected benefits and assess these against their knowledge of the business and the market in which it operates.

(v) It may be appropriate to request management representations on the appropriateness of the changes in accounting estimates.

(vi) In general, the auditor should obtain the schedules supporting the financial statements and re-calculate a sample of depreciation entries relating to individual properties and classes of properties, and ensure that appropriate adjustments have been made in respect of revalued assets.

(vii) The auditor should also perform analytical procedures on the depreciation charge, although the predictive value of this on an overall basis will be diminished in the current year as changes in accounting estimates have been made. It will be more useful in reviewing charges for individual classes of properties.

This marking scheme is given as a guide in the context of the suggested answers. Scope is given to markers to award marks for alternative approaches to a question, including relevant comment, and where well-reasoned conclusions are provided. This is particularly the case for written answers where there may be more than one definitive solution.

				Marks
1	**(a)**	Property, plant and equipment		1
		goodwill		1
		negative goodwill – calculation		4
		– realisation		2
		investments		1
		current assets		2
		current liabilities		2
		10% loan note		2
		deferred consideration		2
		minority interest		3
		share capital and premium of Hilda		1
		accumulated profits		3
			available	24
			maximum	**20**
	(b)	I mark per relevant point to	**maximum**	**5**
			Maximum for question	**25**
2	**(a)**	Income statement		
		sales revenue		1
		cost of sales		2
		operating costs		1
		disclosure of discontinuing operations figures		2
		finance costs		2
		gain on investment property		1
		exchange loss		1
		taxation		2
			available	12
			maximum	**10**
	(b)	Changes in equity		
		profit for period		1
		dividend paid		1
		dividend declared		1
			maximum	**3**
	(c)	Balance sheet		
		investment property		1
		property, plant and equipment		2
		current assets		3
		preference shares		1
		decommissioning costs		2
		deferred tax		1
		income tax liability		1
		declared dividend		1
		accrued finance costs		1
			available	13
			maximum	**12**
			Maximum for question	**25**

					Marks
3	(a)	(i)	1 mark per relevant point to a	maximum	2
		(ii)	1 mark per relevant point to a	maximum	2
		(iii)	1 mark per relevant point to a	maximum	3
	(b)	(i)	1 mark per relevant point to a	maximum	4
		(ii)	average carrying amount of $6 million		1
			weighted average cost of capital		1
			suspension for two months, but not the two weeks		1
			resultant calculation		1
				available	4
				maximum	**4**
				Maximum for question	**15**

4	(a)	(i)	1 mark per relevant point to a	maximum	2
		(ii)	1 mark per relevant point to a	maximum	3
	(b)		basic calculation		
			deduction of preference dividends		1
			based on 7·2 million shares		1
			dilution		
			ranking of items – I mark for each item		3
			10% preference shares not dilutive		1
			use of control earnings figure		2
			treatment of directors options and loan stock in calculation		2
				maximum	**10**
				Maximum for question	**15**

5	(a)	Identity of those charged with governance and matters to be communicated		
		Identity		
		Up to 2 marks per point to a maximum of		4
		Nature of matters to be reported		
		Up to 1 mark per point to a maximum of		7
	(b)	Issues where senior management lacks integrity or maybe engaging in illegal activities		
		Up to 1·5 marks per point to a maximum of		9
			Total	**20**

6	(a)	Risks to the firm and difficulties		
		Up to 2 marks per point to a maximum of		8
	(b)	ISA 720		
		Up to 1·5 marks per point to a maximum of		7
			Total	**15**

7	(a)	Revalued assets		
		Up to 1 mark per point to a maximum of		10
		NB: no more than 5 marks for valuation – the remainder to be allocated to the impairment review		
	(b)	Depreciation charges		
		Up to 1 mark per point to a maximum of		5
			Total	**15**