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Answers

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1 (a) Cost of control in Sunlee:

	$'000		$'000
Consideration			
Shares (20,000 x 80% x 3/5 x $5)			48,000
Less			
Equity shares	20,000		
Pre acq reserves	18,000		
Fair value adjustments (4,000 + 3,000 + 5,000)	12,000		
	50,000	x 80%	(40,000)
Goodwill			8,000

(b) Carrying amount of Amber 30 September 2006 (prior to impairment loss):

	$'000
At cost	
Cash (6,000 x $3)	18,000
6% loan notes (6,000 x $100/100)	6,000
	24,000
Less	
Post acquisition losses (20,000 x 40% x 3/12)	(2,000)
	22,000

(c) Hosterling Group
Consolidated income statement for the year ended 30 September 2006

	$'000
Revenue (105,000 + 62,000 – 18,000 intra group)	149,000
Cost of sales (see working)	(89,000)
Gross profit	60,000
Distribution costs (4,000 + 2,000)	(6,000)
Administrative expenses (7,500 + 7,000)	(14,500)
Finance costs (1,200 + 900)	(2,100)
Impairment losses:	
Goodwill	(1,600)
Investment in associate (22,000 – 21,500)	(500)
Share of loss from associate (20,000 x 40% x 3/12)	(2,000)
Profit before tax	33,300
Income tax expense (8,700 + 2,600)	(11,300)
Profit for the period	22,000
Attributable to:	
Equity holders of the parent	19,600
Minority Interest ((13,000 – 1,000 depreciation adjustment) x 20%)	2,400
	22,000

Note: the dividend from Sunlee is eliminated on consolidation.

Working	$'000
Cost of sales	
Hosterling	68,000
Sunlee	36,500
Intra group purchases	(18,000)
Additional depreciation of plant (5,000/5 years)	1,000
Unrealised profit in inventories (7,500 x 25%/125%)	1,500
	89,000

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2 (a) Tadeon – Income statement – Year to 30 September 2006

	$'000	$'000
Revenue		277,800
Cost of sales (w (i))		(144,000)
Gross profit		133,800
Operating expenses (40,000 + 1,200 (w (ii)))		(41,200)
Investment income		2,000
Finance costs – finance lease (w (ii))	(1,500)	
– loan (w (iii))	(2,750)	(4,250)
Profit before tax		90,350
Income tax expense (w (iv))		(36,800)
Profit for the period		53,550

(b) Tadeon – Balance Sheet as at 30 September 2006

	$'000	$'000
Non-current assets		
Property, plant and equipment (w (v))		299,000
Investments at amortised cost		42,000
		341,000
Current assets		
Inventories	33,300	
Trade receivables	53,500	86,800
Total assets		427,800
Equity and liabilities		
Capital and reserves:		
Equity shares of 20 cents each fully paid (w (vi))		200,000
Reserves		
Share premium (w (vi))	28,000	
Revaluation reserve (w (v))	16,000	
Retained earnings (w (vii))	42,150	86,150
		286,150
Non-current liabilities		
2% Loan note (w (iii))	51,750	
Deferred tax (w (iv))	14,800	
Finance lease obligation (w (ii))	10,500	77,050
Current liabilities		
Trade payables	18,700	
Accrued lease finance costs (w (ii))	1,500	
Finance lease obligation (w (ii))	4,500	
Bank overdraft	1,900	
Income tax payable (w (iv))	38,000	64,600
Total equity and liabilities		427,800

Workings (note figures in brackets are in $'000)

(i) Cost of sales:

	$'000
Per trial balance	118,000
Depreciation (12,000 + 5,000 + 9,000 w (v))	26,000
	144,000

(ii) Vehicle rentals/finance lease:

The total amount of vehicle rentals is $6·2 million of which $1·2 million are operating lease rentals and $5 million is identified as finance lease rentals. The operating rentals have been included in operating expenses.

Finance lease	$'000
Fair value of vehicles	20,000
First rental payment – 1 October 2005	(5,000)
Capital outstanding to 30 September 2006	15,000
Accrued interest 10% (current liability)	1,500
Total outstanding 30 September 2006	16,500

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In the year to 30 September 2007 (i.e. on 1 October 2006) the second rental payment of $6 million will be made, of this $1·5 million is for the accrued interest for the previous year, thus $4·5 million will be a capital repayment. The remaining $10·5 million (16,500 – (4,500 + 1,500)) will be shown as a non-current liability.

(iii) Although the loan has a nominal (coupon) rate of only 2%, amortisation of the large premium on redemption, gives an effective interest rate of 5·5% (from question). This means the finance charge to the income statement will be a total of $2·75 million (50,000 x 5·5%). As the actual interest paid is $1 million an accrual of $1·75 million is required. This amount is added to the carrying amount of the loan in the balance sheet.

(iv) Income tax and deferred tax

The income statement charge is made up as follows:	$'000
Current year's provision	38,000
Deferred tax (see below)	(1,200)
	36,800

There are $74 million of taxable temporary differences at 30 September 2006. With an income tax rate of 20%, this would require a deferred tax liability of $14·8 million (74,000 x 20%). $4 million ($20m x 20%) is transferred to deferred tax in respect of the revaluation of the leasehold property (and debited to the revaluation reserve), thus the effect of deferred tax on the income statement is a credit of $1·2 million (14,800 – 4,000 – 12,000 b/f).

(v) Non-current assets/depreciation:

Non-leased plant

This has a carrying amount of $96 million (181,000 – 85,000) prior to depreciation of $12 million at $12^1/_2$% reducing balance to give a carrying amount of $84 million at 30 September 2006.

The leased vehicles will be included in non-current assets at their fair value of $20 million and depreciated by $5 million (four years straight-line) for the year ended 30 September 2006 giving a carrying amount of $15 million at that date.

The 25 year leasehold property is being depreciated at $9 million per annum (225,000/25 years). Prior to its revaluation on 30 September 2006 there would be a further year's depreciation charge of $9 million giving a carrying amount of $180 million (225,000 – (36,000 + 9,000)) prior to its revaluation to $200 million. Thus $20 million would be transferred to a revaluation reserve. The question says the revaluation gives rise to $20 million of the deductible temporary differences, at a tax rate of 20%, this would give a credit to deferred tax of $4 million which is debited to the revaluation reserve to give a net balance of $16 million. Summarising:

	cost/valuation	accumulated depreciation	carrying amount
	$,000	$,000	$,000
25 year leasehold property	200,000	nil	200,000
Non-leased plant	181,000	97,000	84,000
Leased vehicles	20,000	5,000	15,000
	401,000	102,000	299,000

(vi) Suspense account

The called up share capital of $150 million in the trial balance represents 750 million shares (150m/0·2) which have a market value at 1 October 2005 of $600 million (750m x 80 cents). A yield of 5% on this amount would require a $30 million dividend to be paid.

A fully subscribed rights issue of one new share for every three shares held at a price of 32c each would lead to an issue of 250 million (150m/0·2 x 1/3). This would yield a gross amount of $80 million, and after issue costs of $2 million, would give a net receipt of $78 million. This should be accounted for as $50 million (250m x 20 cents) to equity share capital and the balance of $28 million to share premium.

The receipt from the share issue of $78 million less the payment of dividends of $30 million reconciles the suspense account balance of $48 million.

(vii) Retained earnings

	$,000
At 1 October 2005	18,600
Year to 30 September 2006	53,550
less dividends paid (w (vi))	(30,000)
	42,150

3 **(a)** Most forms of off balance sheet financing have the effect of what is, in substance, debt finance either not appearing on the balance sheet at all or being netted off against related assets such that it is not classified as debt. Common examples would be structuring a lease such that it fell to be treated as an operating lease when it has the characteristics of a finance lease, complex financial instruments classified as equity when they may have, at least in part, the substance of debt and 'controlled' entities having large borrowings (used to benefit the group as a whole), that are not consolidated because the financial structure avoids the entities meeting the definition of a subsidiary.

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The main problem of off balance sheet finance is that it results in financial statements that do not faithfully represent the transactions and events that have taken place. Faithful representation is an important qualitative characteristic of useful information (as described in the *Framework for the preparation and presentation of financial statements*). Financial statements that do not faithfully represent that which they purport to lack reliability. A lack of reliability may mean that any decisions made on the basis of the information contained in financial statements are likely to be incorrect or, at best, sub-optimal.

The level of debt on a balance sheet is a direct contributor to the calculation of an entity's balance sheet gearing, which is considered as one of the most important financial ratios. It should be understood that, to a point, the use of debt financing is perfectly acceptable. Where balance sheet gearing is considered low, borrowing is relatively inexpensive, often tax efficient and can lead to higher returns to shareholders. However, when the level of borrowings becomes high, it increases risk in many ways. Off balance sheet financing may lead to a breach of loan covenants (a serious situation) if such debt were to be recognised on the balance sheet in accordance with its substance.

High gearing is a particular issue to equity investors. Equity (ordinary shares) is sometimes described as residual return capital. This description identifies the dangers (to equity holders) when an entity has high gearing. The dividend that the equity shareholders might expect is often based on the level of reported profits. The finance cost of debt acts as a reduction of the profits available for dividends. As the level of debt increases, higher interest rates are also usually payable to reflect the additional risk borne by the lender, thus the higher the debt the greater the finance charges and the lower the profit. Many off balance sheet finance schemes also disguise or hide the true finance cost which makes it difficult for equity investors to assess the amount of profits that will be needed to finance the debt and consequently how much profit will be available to equity investors. Furthermore, if the market believes or suspects an entity is involved in 'creative accounting' (and off balance sheet finance is a common example of this) it may adversely affect the entity's share price.

An entity's level of gearing will also influence any decision to provide further debt finance (loans) to the entity. Lenders will consider the nature and value of the assets that an entity owns which may be provided as security for the borrowings. The presence of existing debt will generally increase the risk of default of interest and capital repayments (on further borrowings) and existing lenders may have a prior charge on assets available as security. In simple terms if an entity has high borrowings, additional borrowing is more risky and consequently more expensive. A prospective lender to an entity that already has high borrowings, but which do not appear on the balance sheet is likely to make the wrong decision. If the correct level of borrowings were apparent, either the lender would not make the loan at all (too high a lending risk) or, if it did make the loan, it would be on substantially different terms (e.g. charge a higher interest rate) so as to reflect the real risk of the loan.

Some forms of off balance sheet financing may specifically mislead suppliers that offer credit. It is a natural precaution that a prospective supplier will consider the balance sheet strength and liquidity ratios of the prospective customer. The existence of consignment inventories may be particularly relevant to trade suppliers. Sometimes consignment inventories and their related current liabilities are not recorded on the balance sheet as the wording of the purchase agreement may be such that the legal ownership of the goods remains with the supplier until specified events occur (often the onward sale of the goods). This means that other suppliers cannot accurately assess an entity's true level of trade payables and consequently the average payment period to suppliers, both of which are important determinants in deciding whether to grant credit.

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(b) **(i)** Debt factoring is a common method of entities releasing the liquidity of their trade receivables. The accounting issue that needs to be decided is whether the trade receivables have been sold, or whether the income from the finance house for their 'sale' should be treated as a short term loan. The main substance issue with this type of transaction is to identify which party bears the risks (i.e. of slow and non-payment by the customer) relating to the asset. If the risk lies with the finance house (Omar), the trade receivables should be removed from the balance sheet (derecognised in accordance with IAS 39). In this case it is clear that Angelino still bears the risk relating to slow and non-payment. The residual payment by Omar depends on how quickly the receivables are collected; the longer it takes, the less the residual payment (this imputes a finance cost). Any balance uncollected by Omar after six months will be refunded by Angelino which reflects the non-payment risk.

Thus the correct accounting treatment for this transaction is that the cash received from Omar (80% of the selected receivables) should be treated as a current liability (a short term loan) and the difference between the gross trade receivables and the amount ultimately received from Omar (plus any amounts directly from the credit customers themselves) should be charged to the income statement. The classification of the charge is likely to be a mixture of administrative expenses (for Omar collecting receivables), finance expenses (reflecting the time taken to collect the receivables) and the impairment of trade receivables (bad debts).

(ii) This is an example of a sale and leaseback of a property. Such transactions are part of normal commercial activity, often being used as a way to improve cash flow and liquidity. However, if an asset is sold at an amount that is different to its fair value there is likely to be an underlying reason for this. In this case it appears (based on the opinion of the auditor) that Finaid has paid Angelino $2 million more than the building is worth. No (unconnected) company would do this knowingly without there being some form of 'compensating' transaction. This sale is 'linked' to the five year rental agreement. The question indicates the rent too is not at a fair value, being $500,000 per annum ($1,300,000 – $800,000) above what a commercial rent for a similar building would be.

It now becomes clear that the excess purchase consideration of $2 million is an 'in substance' loan (rather than sales proceeds – the legal form) which is being repaid through the excess ($500,000 per annum) of the rentals. Although this is a sale and leaseback transaction, as the building is freehold and has an estimated remaining life (20 years) that is much longer than the five year leaseback period, the lease is not a finance lease and the building should be treated as sold and thus derecognised.

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The correct treatment for this item is that the sale of the building should be recorded at its fair value of $10 million, thus the profit on disposal would be $2·5 million ($10 million – $7·5 million). The 'excess' of $2 million ($12 million – $10 million) should be treated as a loan (non-current liability). The rental payment of $1·3 million should be split into three elements; $800,000 building rental cost, $200,000 finance cost (10% of $2 million) and the remaining $300,000 is a capital repayment of the loan.

(iii) The treatment of consignment inventory depends on the substance of the arrangements between the manufacturer and the dealer (Angelino). The main issue is to determine if and at what point in time the cars are 'sold'. The substance is determined by analysing which parties bear the risks (e.g. slow moving/obsolete inventories, finance costs) and receive the benefits (e.g. use of inventories, potential for higher sales, protection from price increases) associated with the transaction.

Supplies from Monza
Angelino has, and has actually exercised, the right to return the cars without penalty (or been required by Monza to transfer them to another dealer), which would indicate that it has not 'bought' the cars. There are no finance costs incurred by Angelino, however Angelino would suffer from any price increases that occurred during the three month holding/display period. These factors seem to indicate that the substance of this arrangement is the same as its legal form i.e. Monza should include the cars in its balance sheet as inventory and therefore Angelino will not record a purchase transaction until it becomes obliged to pay for the cars (three months after delivery or until sold to customers if sooner).

Supplies from Capri
Although this arrangement seems similar to the above, there are several important differences. Angelino is bearing the finance costs of 1% per month (calling it a display charge is a distraction). The option to return the cars should be ignored because it is not likely to be exercised due to commercial penalties (payment of transport costs and loss of deposit). Finally the purchase price is fixed at the date of delivery rather than at the end of six months. These factors strongly indicate that Angelino bears the risks and rewards associated with ownership and should recognise the inventory and the associated liability in its financial statements at the date of delivery.

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4 (a) Cash Flow Statement of Minster for the Year ended 30 September 2006:

	$000	$000
Cash flows from operating activities		
Profit before tax		142
Adjustments for:		
Depreciation of property, plant and equipment	255	
Amortisation of software (180 – 135)	45	300
Investment income		(20)
Finance costs		40
		462
Working capital adjustments		
Decrease in trade receivables (380 – 270)	110	
Increase in amounts due from construction contracts (80 – 55)	(25)	
Decrease in inventories (510 – 480)	30	
Decrease in trade payables (555 – 350)	(205)	(90)
Cash generated from operations		372
Interest paid (40 – 12 re unwinding of environmental provision)		(28)
Income taxes paid (w (ii))		(54)
Net cash from operating activities		290
Cash flows from investing activities		
Purchase of – property, plant and equipment (w (i))	(410)	
– software	(180)	
– investments (150 – (15 + 125))	(10)	
Investment income received (20 – 15 gain on investments)	5	
Net cash used in investing activities		(595)
Cash flows from financing activities		
Proceeds from issue of equity shares (w (iii))	265	
Proceeds from issue of 9% loan note	120	
Dividends paid (500 x 4 x 5 cents)	(100)	
Net cash from financing activities		285
Net decrease in cash and cash equivalents		(20)
Cash and cash equivalents at beginning of period (40 – 35)		(5)
Cash and cash equivalents at end of period		(25)

Note: interest paid may be presented under financing activities and dividends paid may be presented under operating activities.

Workings (in $'000)

(i) Property, plant and equipment:

carrying amount b/f	940
non-cash environmental provision	150
revaluation	35
depreciation for period	(255)
carrying amount c/f	(1,280)
difference is cash acquisitions	(410)

(ii) Taxation:

tax provision b/f	(50)
deferred tax b/f	(25)
income statement charge	(57)
tax provision c/f	60
deferred tax c/f	18
difference is cash paid	(54)

(iii) Equity shares

balance b/f	(300)
bonus issue (1 for 4)	(75)
balance c/f	500
difference is cash issue	125

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Share premium	
balance b/f	(85)
bonus issue (1 for 4)	75
balance c/f	150
difference is cash issue	140

Therefore the total proceeds of cash issue of shares are $265,000 (125 + 140).

(b) Report on the financial position of Minster for the year ended 30 September 2006

To:
From:
Date:

Minster shows healthy operating cash inflows of $372,000 (prior to finance costs and taxation). This is considered by many commentators as a very important figure as it is often used as the basis for estimating the company's future maintainable cash flows. Subject to (inevitable) annual expected variations and allowing for any changes in the company's structure this figure is more likely to be repeated in the future than most other figures in the cash flow statements which are often 'one-off' cash flows such as raising loans or purchasing non-current assets. The operating cash inflow compares well with the underlying profit before tax $142,000. This is mainly due to depreciation charges of $300,000 being added back to the profit as they are a non-cash expense. The cash inflow generated from operations of $372,000 together with the reduction in net working capital of $90,000 is more than sufficient to cover the company's taxation payments of $54,000, interest payments of $28,000 and the dividend of $100,000 and leaves an amount to contribute to the funding of the increase in non-current assets. It is important that these short term costs are funded from operating cash flows; it would be of serious concern if, for example, interest or income tax payments were having to be funded by loan capital or the sale of non-current assets.

There are a number of points of concern. The dividend of $100,000 gives a dividend cover of less than one (85/100 = 0·85) which means the company has distributed previous year's profits. This is not a tenable situation in the long-term. The size of the dividend has also contributed to the lower cash balances (see below). There is less investment in both inventory levels and trade receivables. This may be the result of more efficient inventory control and better collection of receivables, but it may also indicate that trading volumes may be falling. Also of note is a large reduction in trade payable balances of $205,000. This too may be indicative of lower trading (i.e. less inventory purchased on credit) or pressure from suppliers to pay earlier. Without more detailed information it is difficult to come to a conclusion in this matter.

Investing activities:
The cash flow statement shows considerable investment in non-current assets, in particular $410,000 in property, plant and equipment. These acquisitions represent an increase of 44% of the carrying amount of the property, plant and equipment as at the beginning of the year. As there are no disposals, the increase in investment must represent an increase in capacity rather than the replacement of old assets. Assuming that this investment has been made wisely, this should bode well for the future (most analysts would prefer to see increased investment rather than contraction in operating assets). An unusual feature of the required treatment of environmental provisions is that the investment in non-current assets as portrayed by the cash flow statement appears less than if balance sheet figures are used. The balance sheet at 30 September 2006 includes $150,000 of non-current assets (the discounted cost of the environmental provision), which does not appear in the cash flow figures as it is not a cash 'cost'. A further consequence is that the 'unwinding' of the discounting of the provision causes a financing expense in the income statement which is not matched in the cash flow statement as the unwinding is not a cash flow. Many commentators have criticised the required treatment of environmental provisions because they cause financing expenses which are not (immediate) cash costs and no 'loans' have been taken out. Viewed in this light, it may be that the information in the cash flow statement is more useful than that in the income statement and balance sheet.

Financing activities:
The increase in investing activities (before investment income) of $600,000 has been largely funded by an issue of shares at $265,000 and raising a 9% $120,000 loan note. This indicates that the company's shareholders appear reasonably pleased with the company's past performance (or they would not be very willing to purchase further shares). The interest rate of the loan at 9% seems quite high, and virtually equal to the company's overall return on capital employed of 9·1% (162/(1,660 + 120)). Provided current profit levels are maintained, it should not reduce overall returns to shareholders.

Cash position:
The overall effect of the year's cash flows has worsened the company's cash position by an increased net cash liability of $20,000. Although the company's short term borrowings have reduced by $15,000, the cash at bank of $35,000 at the beginning of the year has now gone. In comparison to the cash generation ability of the company and considering its large investment in non-current assets, this $20,000 is a relatively small amount and should be relieved by operating cash inflows in the near future.

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Summary
The above analysis shows that Minster has invested substantially in new non-current assets suggesting expansion. To finance this, the company appears to have no difficulty in attracting further long-term funding. At the same time there are indications of reduced inventories, trade receivables and payables which may suggest the opposite i.e. contraction. It may be that the new investment is a change in the nature of the company's activities (e.g. mining) which has different working capital characteristics. The company has good operating cash flow generation and the slight deterioration in short term net cash balance should only be temporary.

Yours …………………..

5 (a) (i) IFRS 5 *Non-current assets held for sale and discontinued operations* defines non-current assets held for sale as those assets (or a group of assets) whose carrying amounts will be recovered principally through a sale transaction rather than through continuing use. A discontinued operation is a component of an entity that has either been disposed of, or is classified as 'held for sale' and:

(i) represents a separate major line of business or geographical area of operations
(ii) is part of a single co-ordinated plan to dispose of such, or
(iii) is a subsidiary acquired exclusively for sale.

IFRS 5 says that a 'component of an entity' must have operations and cash flows that can be clearly distinguished from the rest of the entity and will in all probability have been a cash-generating unit (or group of such units) whilst held for use. This definition also means that a discontinued operation will also fall to be treated as a 'disposal group' as defined in IFRS 5. A disposal group is a group of assets (possibly with associated liabilities) that it is intended will be disposed of in a single transaction by sale or otherwise (closure or abandonment). Assets held for disposal (but not those being abandoned) must be presented separately (at the lower of cost or fair value less costs to sell) from other assets and included as current assets (rather than as non-current assets) and any associated liabilities must be separately presented under liabilities. The results of a discontinued operation should be disclosed separately as a single figure (as a minimum) on the face of the income statement with more detailed figures disclosed either also on the face of the income statement or in the notes.

The intention of this requirement is to improve the usefulness of the financial statements by improving the predictive value of the (historical) income statement. Clearly the results from discontinued operations should have little impact on future operating results. Thus users can focus on the continuing activities in any assessment of future income and profit.

(ii) The timing of the board meeting and consequent actions and notifications is within the accounting period ended 31 October 2006. The notification of staff, suppliers and the press seems to indicate that the sale will be highly probable and the directors are committed to a plan to sell the assets and are actively locating a buyer. From the financial and other information given in the question it appears that the travel agencies' operations and cash flows can be clearly distinguished from its other operations. The assets of the travel agencies appear to meet the definition of non-current assets held for sale; however the main difficulty is whether their sale and closure also represent a discontinued operation. The main issue is with the wording of 'a separate major line of business' in part (i) of the above definition of a discontinued operation. The company is still operating in the holiday business, but only through Internet selling. The selling of holidays through the Internet compared with through high-street travel agencies requires very different assets, staff knowledge and training and has a different cost structure. It could therefore be argued that although the company is still selling holidays the travel agencies do represent a separate line of business. If this is the case, it seems the announced closure of the travel agencies appears to meet the definition of a discontinued operation.

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(iii) Partway income statement year ended:

	31 October 2006 $'000	31 October 2005 $'000
Continuing operations		
Revenue	25,000	22,000
Cost of sales	(19,500)	(17,000)
Gross profit	5,500	5,000
Operating expenses	(1,100)	(500)
Profit/(loss) from continuing operations	4,400	4,500
Discontinued operations		
Profit/(loss) from discontinued operations	(4,000)	1,500
Profit for the period	400	6,000
Analysis of discontinued operations		
Revenue	14,000	18,000
Cost of sales	(16,500)	(15,000)
Gross profit/(loss)	(2,500)	3,000
Operating expenses	(1,500)	(1,500)
Profit/(loss) from discontinued operations	(4,000)	1,500

Note: other presentations may be acceptable.

(b) (i) Comparability is one of the four principal qualitative characteristics of useful financial information. It is a vital attribute when assessing the performance of an entity over time (trend analysis) and to some extent with other similar entities. For information to be comparable it should be based on the consistent treatment of transactions and events. In effect a change in an accounting policy breaks the principle of consistency and should generally be avoided. That said there are circumstances where it becomes necessary to change an accounting policy. These are mainly where it is required by a new or revised accounting standard, interpretation or applicable legislation or where the change would result in financial statements giving a more reliable and relevant representation of the entity's transactions and events.

It is important to note that the application of a different accounting policy to transactions or events that are substantially different to existing transactions or events or to transactions or events that an entity had not previously experienced does NOT represent a change in an accounting policy. It is also necessary to distinguish between a change in an accounting policy and a change in an estimation technique.

In an attempt to limit the problem of reduced comparability caused by a change in an accounting policy, the general principle is that the financial statements should be prepared as if the new accounting policy had always been in place. This is known as retrospective application. The main effect of this is that comparative financial statements should be restated by applying the new policy to them and adjusting the opening balance of each component of equity affected in the earliest prior period presented. IAS 8 *Accounting policies, changes in accounting estimates and errors* says that a change in accounting policy required by a specific Standard or Interpretation should be dealt with under the transitional provisions (if any) of that Standard or Interpretation (normally these apply the general rule of retrospective application). There are some limited exemptions (mainly on the grounds of impracticality) to the general principle of retrospective application in IAS 8.

(ii) This issue is one of the timing of when revenue should be recognised in the income statement. This can be a complex issue which involves identifying the transfer of significant risks, reliable measurement, the probability of receiving economic benefits, relevant accounting standards and legislation and generally accepted practice. Applying the general guidance in IAS 18 *Revenue*, the previous policy, applied before cancellation insurance was made a condition of booking, seemed appropriate. At the time the holiday is taken it can no longer be cancelled, all monies would have been received and the flights and accommodation have been provided. There may be some compensation costs involved if there are problems with the holiday, but this is akin to product warranties on normal sales of goods which may be immaterial or provided for based on previous experience of such costs. The appendix to IAS 18 specifically refers to payments in advance of the 'delivery' of goods and says that revenue should be recognised when the goods are delivered. Interpreting this for Partway's transaction would seem to confirm the appropriateness of its previous policy.

The directors of Partway wish to change the timing of recognition of sales because of the change in circumstances relating to the compulsory cancellation insurance. The directors are apparently arguing that the new 'transactions and events' are substantially different to previous transactions therefore the old policy should not apply. Even if this does justify revising the timing of the recognition of revenue, it is not a change of accounting policy because of the reasons outlined in (i) above.

An issue to consider is whether compulsory cancellation insurance represents a substantial change to the risks that Partway experiences. An analysis of past experience of losses caused by uninsured cancellations may help to assess this, but even if the past losses were material (and in future they won't be), it is unlikely that this would override the general guidance in the appendix to IAS 18 relating to payments made in advance of delivery. It seems the main motivation for the proposed change is to improve the profit for the year ended 31 October 2006 so that it compares more favourably with that of the previous period.

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To summarise, it is unlikely that the imposition of compulsory cancellation insurance justifies recognising sales at the date of booking when a deposit is received, and, even if it did, it would not be a change in accounting policy. This means that comparatives would not be restated (which is something that would actually suit the suspected objectives of the directors).

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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 acceptable solution.

				Marks
1	**(a)**	Goodwill of Sunlee:		
		consideration		1
		equity shares		1
		pre acquisition reserves		1
		fair value adjustments		2
			maximum	**5**
	(b)	Carrying amount and impairment of Amber:		
		cash paid		1
		6% loan note		1
		post acquisition loss		2
			maximum	**4**
	(c)	Income statement:		
		revenue		2
		cost of sales		4
		distribution costs and administrative expenses		1
		finance costs		1
		impairment of goodwill		1
		impairment of associate		1
		share of associate's loss		2
		income tax		1
		minority interests		2
		eliminate dividend from Sunlee		1
			maximum	**16**
			Maximum for question	**25**
2	**(a)**	Income statement		
		revenue		1
		cost of sales		2
		operating expenses		1
		investment income		1
		finance costs		2
		income tax expense		3
			available	10
			maximum	**8**
	(b)	Balance sheet		
		property, plant and equipment		3
		investment		1
		inventory and trade receivables		1
		share capital and premium		3
		revaluation reserve		2
		retained earnings (including 1 mark for the dividend)		2
		loan note		2
		deferred tax		1
		lease obligation (1 for current, 1 for long-term)		2
		trade payables and overdraft		1
		accrued lease finance costs		1
		income tax payable		1
			available	20
			maximum	**17**
			Maximum for question	**25**

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					Marks
3	(a)		1 mark per relevant point to a	**maximum**	**9**
	(b)	(i)	1 mark per relevant point to a	**maximum**	**5**
		(ii)	sale price not at fair value raises substance issues		1
			leaseback is not a finance lease		1
			treat building as sold (derecognise) at a profit of $2·5 million		1
			rental treated as: $800,000 rental cost		1
			$200,000 finance cost		1
			$300,000 loan repayment		1
				maximum	**6**
		(iii)	general discussion of risks and rewards re consignment goods		2
			Issues and accounting treatment relating to supplies from Monza		2
			Issues and accounting treatment relating to supplies from Capri		2
				available	6
				maximum	**5**
				Maximum for question	**25**
4	(a)		cash flow from operating activity		
			profit before tax adjusted for investment income and finance cost		1
			depreciation/amortisation		2
			working capital items		2
			finance costs		2
			income taxes paid		2
			investing activities (including 1 for investment income)		4
			financing – issue of ordinary shares		1
			– issue of 9% loan		1
			dividend paid		1
			cash and cash equivalents b/f and c/f		1
				available	17
				maximum	**15**
	(b)		1 mark per relevant point		10
				Maximum for question	**25**
5	(a)	(i)	definitions		2
			usefulness of information		2
				maximum	**4**
		(ii)	discussion of whether a discontinued operation		3
			conclusion		1
				maximum	**4**
		(iii)	figures for revenue from continuing operations (2005 and 2006)		1
			figures for revenue from discontinued operations (2005 and 2006)		1
			figures for cost of sales from continuing operations (2005 and 2006)		1
			figures for cost of sales from discontinued operations (2005 and 2006)		1
			figures for profit from continuing operations (2005 and 2006)		1
			figures for profit from discontinued operations (2005 and 2006)		1
				maximum	**6**
	(b)	(i)	1 mark per relevant point	**maximum**	**5**
		(ii)	1 mark per relevant point	**maximum**	**6**
				Maximum for question	**25**

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