Answers

1 (a) (i) Marchant Group: Statement of profit or loss and other comprehensive income for the year ended 30 April 2014

	$m
Revenue	538
Cost of sales	(383)
Gross profit	155
Other income	45·7
Administrative costs	(30)
Other expenses	(74·69)
Share of profits of associates	1·5
Operating profit	97·51
Finance costs	(10)
Finance income	15
Profit before tax	102·51
Income tax expense	(30·5)
Profit for the year	72·01
Other comprehensive income:	
Items which will not be reclassified to profit or loss	
Changes in revaluation surplus	2·8
Remeasurements – defined benefit plan	(2)
Total items which will not be reclassified subsequently to profit or loss	0·8
Items which may be reclassified subsequently to profit or loss	
Losses on cash flow hedge	(3)
Other comprehensive loss for the year	(2·2)
Total comprehensive income for the year	69·81
Profit/loss attributable to: (w7)	
Owners of the parent	60·21
Non-controlling interest	11·8
	72·01

Total comprehensive income attributable to:

	$m
Owners of the parent	59·21
Non-controlling interest	10·6
	69·81

Working 1

(Note that this is purely a working and does not purport to show necessarily what would be reported in the individual accounts)

	Marchant $m	Nathan $m	Option $m	Adjustment	Total $m
Revenue	400	115	35	(12)	538
Cost of sales	(312)	(65)	(18)	12	(383)
Gross profit	88	50	17		155
Other income (21 – 5·3 + 22) W2/W3	37·7	7	1		45·7
Administrative costs	(15)	(9)	(6)		(30)
Other expenses	(35)	(19)	(4)		
Impairment of goodwill	(5)				
Share of profits of associates	1·5				
Net service cost	(7·2)				
PPE expense	(2·36)				
Share options	(2·13)				(73·19)
Operating profit	60·51	29	8		97·51
Finance costs	(5)	(6)	(2)		(10)
Cash flow hedge to OCI		3			
Finance income	6	5	4		15
Profit before tax	61·51	31	10		102·51
Income tax expense	(19)	(9)	(2·5)		(30·5)
Profit for the year	42·51	22	7·5		72·01
Other comprehensive income					
Remeasurements defined benefit plan	(2)				(2)
Revaluation surplus ($10m – $5m (W2))	5				5
Revaluation adjustment	(2·2)				(2·2)
Cash flow hedge (finance costs reduced by same amount)		(3)			(3)
Other comprehensive income/loss for year	0·8	(3)			(2·2)
Total comprehensive income for year	43·31	19	7·5		69·81

Note that the share of the associates' profit should be disclosed on the face of the statement of profit or loss. Therefore other expenses will be $73·19m plus $1·5m, i.e. $74·69m.

Working 2 Nathan

	$m	$m
Fair value of consideration for 60% interest	80	
Fair value of non-controlling interest	45	125
Fair value of identifiable net assets acquired		(110)
Goodwill		15

Goodwill impairment

After goodwill has been impaired (20% of $15m, i.e. $3m), any subsequent increase in the recoverable amount is likely to be internally generated goodwill rather than a reversal of purchased goodwill impairment. IAS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill, thus any reversal of impairment is not recognised.

Hence $5 million needs to be charged to profit or loss to undo the reversal.

Total impairment is still $3 million.

The gains recorded regarding the investment in Nathan will be follows:

Gain on investment in Nathan ($95m – $90m)	$5m
Gain on sale of holding in Nathan ($18 – (8%/60% of $95m))	$5·3m

No gain or loss is recognised in profit or loss on the sale of Nathan in the group accounts as the sale is shown as a movement in equity. Therefore it is eliminated. Additionally, the gain on the revaluation of the investment in Nathan will also be eliminated on consolidation as the calculation of goodwill will be based on the fair value of the consideration at the date of acquisition and not at the date of the current financial statements.

Working 3 Option

	$m	$m
Fair value of consideration for 60% interest	70	
Fair value of non-controlling interest	28	98
Fair value of identifiable net assets acquired		(86)
Goodwill		12

As Marchant has sold a controlling interest in Option, a gain or loss on disposal should be calculated. Additionally, the results of Option should only be consolidated in the statement of profit or loss and other comprehensive income for the six months to 1 November 2013. Thereafter Option should be equity accounted.

The gain recognised in profit or loss would be as follows:

	$m
Fair value of consideration	50
Fair value of residual interest to be recognised as an associate	40
Value of NCI	34
	124
Less: net assets and goodwill derecognised	
net assets	(90)
goodwill	(12)
Gain on disposal to profit or loss	22

The share of the profits of the associate would be 20% of a half year's profit ($15m/2), i.e. $1·5 million.

Working 4 Defined benefit plan

Pension cost recognised for the year would be	**$m**
Current service cost	4
Net interest cost (10% of $50m – $48m)	0·2
Past service cost	3
Net service cost recognised in profit or loss	7·2
Remeasurements in OCI	2
Net cost for year recognised in total comprehensive income	9·2

IAS 19 does not specify where service cost and net interest cost should be presented. Therefore it is acceptable to include the net interest cost in finance costs. IAS 19 states that past service cost should be recognised immediately and the past service cost will be included in the defined benefit obligation at 1 May 2013. Therefore there is no need to calculate an interest cost on the past service cost.

Working 5 Property, plant and equipment

	$m
Carrying amount at 1 May 2013	13
Depreciation for year ($13m/9)	(1·44)
Carrying amount at 30 April 2014	11·56
Fall in value charged to revaluation surplus ($13m – ($12m – ($12m/10)))	(2·2)
Fall in value charged to profit or loss	(2·36)
Carrying amount after revaluation 30 April 2014	7

Working 6 Share options

Year	Expense for year $m	Cumulative expense $m	Calculation
30 April 2013	1·07	1·07	4 directors x $100 x 8,000 x 1/3
30 April 2014	2·13	3·2	6 directors x $100 x 8,000 x 2/3

Working 7 Non-controlling interest (NCI)

NCI in profits for year is (40% of $22m + 40% of $15 million/2) = $11·8 million
NCI in TCI (40% of 19 + 40% of $15 million/2) = $10·6 million

Working 8

The loss on the sale of the inventory is not eliminated from group profit or loss. Because the sale is at fair value, the inventory value must have been impaired and therefore the loss on sale must remain realised. However, the revenue and cost of sales of $12 million will be eliminated.

(ii) Once control has been achieved, further transactions whereby the parent entity acquires further equity interests from non-controlling interests, or disposes of equity interests but without losing control, are accounted for as equity transactions, that is transactions with owners in their capacity as owners. Thus it follows that:

– the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary;
– any difference between the amount by which the non-controlling interests is adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent; and
– there is no consequential adjustment to the carrying amount of goodwill, and no gain or loss is recognised in profit or loss.

Sale of equity interest in Nathan

	$m
Fair value of consideration received	18
Amount recognised as non-controlling interest (net assets per question at year end ($120m + fair value adjustment PPE at acquisition $14m + goodwill (15 – 3)) x 8%)	(11·7)
Positive movement in parent equity	6·3

The fair value adjustment is $110m – ($25m + $65m + $6m). The income should be shown as a movement in equity not in income. Hence it does not affect the consolidated statement of profit or loss and other comprehensive income.

(b) IFRSs utilise the 'fair value' concept and 'present value' more frequently than some other accounting frameworks. However, it is not a complete fair value system. The IASB has a preference for a mixed system of measurements using a combination of fair value and measurements at depreciated historical cost. IASB bases its standards on the business model of the entity and on the probability of realising the asset and liability-related cash flows through operations or transfers. Fair values, when used in the financial statements, affect the performance measurement and the net assets position and improve the disclosure of risks and of value which may be realisable. IFRS 13 *Fair Value Measurement* was developed to solve the problems in the application of the fair value concept. However, IFRSs do not require that all assets and liabilities are valued at fair value. The financial statements of many entities will measure most items at depreciated historical cost, except where entities grow through acquisition when acquired assets and liabilities are valued at fair value on the acquisition date. However, a revaluation through other comprehensive income is allowed provided it is carried out regularly under IAS 16 *Property, Plant and Equipment* and, in addition, IAS 40 *Investment Property* allows as an option the measurement of investment properties at fair value with corresponding changes in earnings as this better reflects the business model of some property companies. However, the historical cost basis is still regularly used by entities holding investment properties. IAS 38 *Intangible Assets* allows the measurement of intangible assets at fair value, with corresponding changes in equity, but only if there is an active market, and thus a reliable valuation, for these assets.

IFRS 9 *Financial Instruments* replaces the multiple classification and measurement models for financial assets in IAS 39 with a single model which has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual characteristics of the financial assets.

A financial asset is measured at amortised cost if two criteria are met:

(a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and
(b) the contractual cash flows under the instrument solely represent payments of principal and interest.

The new standard removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortised cost or fair value.

As regards derivative financial instruments (swaps, options, future contracts), most of these contracts do not have a cost when signed, and their historical cost is not relevant and obviously it is useless to measure the extent of the commitments undertaken. A market value measurement with matching changes in profit or loss is therefore needed to reflect the risks. This can generate some volatility. Liabilities, except for derivative financial instruments, are recorded at amortised cost. A fair value option is available for financial liabilities, to be used only when some inconsistency should be avoided. In practice, only banks make a limited use of this option for their market transactions.

The fact that IFRSs make some use of fair values in the measurement of assets and liabilities is often misunderstood as meaning that financial statements prepared under IFRSs reflect the aggregate financial value of an entity. The IASB identifies the objective of general purpose financial reporting as being the provision of financial information about the reporting entity which is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. The Conceptual Framework states that general purpose financial reports are not designed to show the value of a reporting entity. The purpose of IFRS financial statements is not to disclose the selling value of the entity, even when some of the identifiable assets and liabilities are recorded at fair value. As IFRSs do not allow an entity to recognise intangible assets generated internally by business operations, any attempt to state the aggregate value of the business would be incomplete.

An entity's net assets are reported at market value only when it is acquired by another entity and consolidated in group accounts.

(c) A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. All other leases are classified as operating leases and classification is made at the inception of the lease. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the legal form. Thus in many circumstances, the classification of a lease can be quite subjective. In the case of a lease of land, this is particularly subjective as the title to the land may not pass to the lessee at the end of the agreement but the lease may still be classed as a finance lease where the present value of the residual value of the land is negligible and the risks and rewards pass to the lessee. Thus, it appears that at first sight this is a difference in a professional opinion, which can be solved by the financial controller seeking advice.

If the features of the lease appear to meet IAS 17 *Leases* criteria for classification as a finance lease and the treatment used is part of a strategy to understate the liabilities of the entity in order to raise a loan, then an ethical dilemma arises. Professional accountants are capable of making judgements, applying their skills and reaching informed decisions in situations where the general public cannot. The judgements made by professional accountants should be independent and not affected by business pressures. The code of ethics is very important because it sets out boundaries outside which accountants should not stray. The financial director should not place the financial controller under undue pressure in order to influence his decisions. If the financial controller is convinced that the lease is a finance lease, then disclosure of this fact should be made to the internal governance authority. The financial controller will have the knowledge that his actions were ethical.

2 **(a)** The functional currency is the currency of the primary economic environment in which the entity operates, which is normally the one in which it primarily generates and expends cash. An entity's management considers the following primary indicators in determining its functional currency:

(a) the currency which mainly influences sales prices for goods and services;
(b) the currency of the country whose competitive forces and regulations mainly determine the sales prices of goods and services; and
(c) the currency which mainly influences labour, material and other costs of providing goods and services.

Further secondary indicators which may also provide evidence of an entity's functional currency are the currency in which funds from financing activities are generated and in which receipts from operating activities are retained.

Additional factors are considered in determining the functional currency of a foreign operation and whether its functional currency is the same as that of the reporting entity. These are:

(a) the autonomy of a foreign operation from the reporting entity;
(b) the level of transactions between the two;
(c) whether the foreign operation generates sufficient cash flows to meet its cash needs; and
(d) whether its cash flows directly affect those of the reporting entity.

When the functional currency is not obvious, management uses its judgement to determine the functional currency which most faithfully represents the economic effects of the underlying transactions, events and conditions.

In the case of Aspire, the subsidiary does not make any decisions as to the investment of funds, and consideration of the currency which influences sales and costs is not relevant. Although the costs are incurred in dollars, they are not material to any decision as to the functional currency. Therefore it is important to look at other factors to determine the functional currency. The subsidiary has issued 2 million dinars of equity capital to Aspire, which is a different currency to that of Aspire, but the proceeds have been invested in dinar denominated bonds at the request of Aspire. The subsidiary has also raised 100,000 dinars of equity capital from external sources but this amount is insignificant compared to the equity issued to Aspire. The income from investments is either remitted to Aspire or reinvested on instruction from Aspire. The subsidiary has a minimum number of staff and does not have any independent management. The subsidiary is simply a vehicle for the parent entity to invest in dinar related investments. Aspire may have set up the entity so that any exposure to the dinar/dollar exchange rate will be reported in other comprehensive income through the translation of the net investment in the subsidiary. There does not seem to be any degree of autonomy as the subsidiary is merely an extension of Aspire's activities. Therefore the functional currency would appear to be the dollar.

In contrast, the dinar represents the currency in which the economic activities of the subsidiary are primarily carried out as is the case regarding the financing of operations and retention of any income not remitted. However, the investment of funds could have been carried out directly by Aspire and therefore the parent's functional currency should determine that of the subsidiary.

(b) Where a foreign branch's taxable profit is determined in a foreign currency, changes in exchange rates may give rise to temporary differences. This can arise where the carrying amounts of the non-monetary assets are translated at historical rates and the tax base of those assets are translated at the rate at the reporting date. An entity may translate the tax base at the year-end rate as this rate gives the best measure of the amount which will be deductible in future periods. The resulting deferred tax is charged or credited to profit or loss.

Property	Dinars (000)	Exchange rate	Dollars (000)
Cost	6,000	5	1,200
Depreciation for year	(500)		(100)
Net book amount	5,500		1,100
Tax base			
Cost	6,000		
Tax depreciation	(750)		
	5,250	6	875
Temporary difference			225
Deferred tax at 20%			45

The deferred tax arising will be calculated using the tax rate in the overseas country. The deferred tax arising is therefore $45,000, which will increase the tax charge in profit or loss. If the historical rate had been used, the tax base would have been $1·05 million (5·25m/5) which would have led to a temporary difference of $50,000 and a deferred tax liability of $10,000, which is significantly lower than when the closing rate is used.

(c) The goodwill arising when a parent acquires a multinational operation with several currencies is allocated to each level of functional currency. Goodwill arising on acquisition of foreign operations and any fair value adjustments are both treated as the foreign operation's assets and liabilities. They are expressed in the foreign operation's functional currency and translated at the closing rate. Exchange differences arising on the retranslation of foreign entities' financial statements are recognised in other comprehensive income and accumulated as a separate component of equity

Exchange rate at 1 May 2013	$1= 5 dinars
Exchange rate at 30 April 2014	$1 =6 dinars
Net assets at fair value	1,100m dinars
Translated at 1 May 2013	$220m
Purchase consideration	$200m
NCI (250m dinars/5)	$50m
Goodwill	$30m
Goodwill treated as foreign currency asset at 1 May 2013 ($30m x 5)	150m dinars
Goodwill translated at closing rate at 30 April 2014 (150m dinars/6)	$25m
Translation adjustment for goodwill in equity	($5m)

An exchange loss of $5 million will be charged in other comprehensive income together with any gain or loss on the retranslation of the net assets of the operations.

(d) The loan balance, as a monetary item, is translated at the spot exchange rate at the year-end date. Interest is translated at the average rate because it approximates to the actual rate. Because the interest is at a market rate for a similar two-year loan, Aspire measures the loan on initial recognition at the transaction price translated into the functional currency. Because there are no transaction costs, the effective interest rate is 8%.

On 1 May 2013, the loan is recorded on initial recognition as follows:

Dr Cash	$1 million
Cr Loan payable – financial liability	$1 million

Year ended 30 April 2014
Aspire records the interest expense as follows:

Dr Profit or loss – interest expense	$71,429
Cr Loan payable – financial liability	$71,429

To recognise interest payable for the year ended 30 April 2014 (0·4 million dinars/5·6).

On 30 April 2014 the interest is paid and the following entry is made:

Dr Loan payable – financial liability	$66,666
Cr Cash	$66,666

To recognise the payment of 2014 interest on financial liability (0·4 million dinars/6).

At 30 April 2014 the loan is recorded at 5 million dinars/6, i.e. $833,333, which gives rise to an exchange gain of $166,667. In addition to this, a further exchange gain of $4,763 arises on the translation of the interest paid ($71,429 – $66,666). The total exchange gain is therefore $171,430.

3 **(a)** Minco needs to consider whether its revenue recognition policy is in compliance with IAS 18 *Revenue*. The criteria for revenue recognition required by paragraph 14 of IAS 18 do not appear to be met, and no revenue should be accounted for as of the date of the transfer of land to the housing association. Revenue arising from the sale of goods should be recognised when all of the following criteria have been satisfied (IAS 18.14):

(a) the seller has transferred to the buyer the significant risks and rewards of ownership;
(b) the seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
(c) the amount of revenue can be measured reliably;
(d) it is probable that the economic benefits associated with the transaction will flow to the seller; and
(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

It is important to consider whether the risks for the project have been transferred to the association and whether Minco has control over the project during the construction period. Even if the risk associated with the land is different to the risk associated with the project directly. Minco should assess the risks for the entire project since it is exposed to material risks during the construction period. Minco provides a guarantee as regards the maintenance costs, is liable for certain increases in the interest rate over expectations, and is responsible for financing variations in the procurement and construction contract which the contractor would not cover. Further, Minco guarantees the payment for the housing association's debt on the building loan. Minco is exposed to risk as if it had built the housing units itself because it gives guarantees in respect of the construction process.

Minco also determines the membership of the board of the housing association and thus there is a question mark over whether the board is independent from Minco. Minco guarantees that the housing association would not be liable if budgeted construction costs are exceeded, so the entity is exposed to financial risk in the construction process.

Minco has retained the significant risks and had effective control of the land it had sold and also the entire construction process. Consequently, the revenue recognition criteria in paragraph 14 of IAS 18 are not met on the transfer of the land and Minco should account for the whole project as if it had built the housing units itself. Accordingly, revenue should be recognised when the housing units are finished and delivered to the buyer of the rights in accordance with IAS 18 which appears to be when the project is completed.

(b) The different payments to the tennis player are not interrelated. Therefore, any interdependencies and interrelations between different forms of payments or specific services and payments need not be examined in order to determine an appropriate expense recognition pattern. The contract relates to advertising and promotional expenditure to improve Minco's brand image by the tennis player. Therefore, in accordance with IAS 38 *Intangible Assets*, the costs must be expensed when the entity has received the service. Any amounts paid in advance of the service being received are recognised as prepayments and expensed when that service is received. The signing bonus of $20,000 is paid to the player on commencement of the contract. In return, the player is obliged to advertise Minco and take part in photo/film sessions. The signing bonus relates to the full contract term and a prepayment of $20,000 is recognised on commencement and is expensed on a straight line basis over the three-year contract period. However, if, from the terms of the contract, separate services can be identified and measured reliably, Minco should allocate the costs and recognise expenses once the separate service is rendered. If the contract is terminated prior to the end of the contract period, any amount not recovered from the player would be expensed immediately.

The player receives the annual retainer at the end of each year, provided she has competed in all of the specified tournaments for that year. Minco has a contractual obligation to deliver cash to the player and, hence, recognises a financial liability during the period, which must be accounted for in accordance with IFRS 9 *Financial Instruments*. The liability is recognised at the point where Minco has an obligation which arises on the date when the player has competed in all the specified tournaments. The financial liability is recognised at the present value of the expected cash flows.

The player also receives additional performance-related payments for success in the tournaments. As these payments relate to specific events, they are treated as executory contracts. They are accrued and expensed when the player has won a tournament.

(c) As regards the improvements to the building through adding an extra floor, Minco should capitalise the costs of the floor in accordance with IAS 16 *Property, Plant and Equipment* and amortise these costs over the six years of the lease. However, Minco has an obligation to remove the floor at the end of the lease. The obligation arises because the completion of the floor creates an obligation event. A provision should be made for the present value of the cost of removal of the floor in six years' time. At the same time an asset should be recognised for the cost. The cost should be recovered from the benefits generated by the new floor over the remainder of the lease. The asset should be amortised over the six-year period. In effect, this is in substance a decommissioning activity.

As regards the disrepair of the building, the estimated costs should be spread over the six years of the agreement. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would indicate that Minco has a present obligation arising from the lease agreement because the landlord can recharge the costs of any repair to Minco. The obligating event is the wear and tear to the building which will arise gradually over the tenancy period and its repair can be enforced through the legal agreement. The obligation relates to wear and tear and is not related to future operating costs. The wear and tear will result in an outflow of economic benefits and a reliable estimate of the yearly obligation arising from this will be made, although it will not necessarily equate to one sixth per year. As regards the roof repair, it is clear from the lease that an obligation exists and therefore a provision should be made for the whole of the rectification work when the need for the repair was identified.

(d) IAS 34 *Interim Financial Reporting* requires an entity to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. Measurements should be made on a 'year to date' basis. In valuing the property, Minco should use the provisions of IFRS 5 *Assets held for Sale and Discontinued Operations*. Immediately before the initial classification of the asset as held for sale, the carrying amount of the asset should be measured in accordance with applicable IFRSs. After classification as held for sale, the property should be measured at the lower of carrying amount and fair value less costs to sell. Impairment must be considered both at the time of classification as held for sale and subsequently in accordance with the applicable IFRSs. Any impairment loss is recognised in profit or loss unless the asset has previously been measured at a revalued amount under IAS 16 or IAS 38, in which case the impairment is treated as a revaluation decrease. A gain for any subsequent increase in fair value less costs to sell of an asset is recognised in the profit or loss to the extent that it is not in excess of the cumulative impairment loss which has been recognised in accordance with IFRS 5 or previously in accordance with IAS 36.

At the time of classification as held for sale, depreciation needs to be charged for the four months to 1 October 2013. This will be based upon the year end value at 31 May 2013 of $2·65 million. The property has 10 years life remaining based upon the depreciation to date and assuming a zero residual value, the depreciation for the four months will be approximately $0·1 million. Thus, at the time of classification as held for sale, after charging depreciation for the four months of $0·1 million, the carrying amount is $2·55 million ($4m – $1 – $0·1m – $0·35m) and fair value less costs to sell is assessed at $2·4 million. Accordingly, the initial write-down on classification as held for sale is $150,000 and the property is carried at $2·4 million. On 1 December 2013 in the interim financial statements, the property market has improved and fair value less costs to sell is reassessed at $2·52 million. The gain of $120,000 is less than the cumulative impairment losses recognised to date ($350,000 plus $150,000, i.e. $500,000). Accordingly, it is credited in profit or loss and the property is carried at $2·52 million. On 31 May 2014, the property market has continued to improve, and fair value less costs to sell is now assessed at $2·95 million. The further gain of $430,000 is, however, in excess of the cumulative impairment losses recognised to date ($350,000 plus $150,000 – $120,000 – $430,000, i.e. $50,000). Accordingly, a restricted gain of $380,000 is credited in profit or loss and the property is carried at $2·9 million. Subsequently, the property is sold for $3 million at which point a gain of $100,000 is recognised. This sale would be a non-adjusting event under IAS 10 *Events after the Reporting Period* if deemed to be material.

4 (a) (i) IAS 32 *Financial Instruments: Presentation* establishes principles for presenting financial instruments as liabilities or equity. To determine whether a financial instrument should be classified as debt or equity, IAS 32 uses principles-based definitions of a financial liability and of equity. In contrast to the requirements of generally accepted accounting practice in many jurisdictions around the world, IAS 32 does not classify a financial instrument as equity or financial liability on the basis of its legal form. The key feature of debt is that the issuer is obliged to deliver either cash or another financial asset to the holder. The contractual obligation may arise from a requirement to repay principal or interest or dividends. Such a contractual obligation may be established explicitly or indirectly through the terms of the agreement. For example, a bond which requires the issuer to make interest payments and redeem the bond for cash is classified as debt. In contrast, equity is any contract which evidences a residual interest in the entity's assets after deducting all of its liabilities. A financial instrument is an equity instrument only if the instrument includes no contractual obligation to deliver cash or another financial asset to another entity and if the instrument will or may be settled in the issuer's own equity instruments. For example, ordinary shares, where all the payments are at the discretion of the issuer, are classified as equity of the issuer. The classification is not quite as simple as it seems. For example, preference shares required to be converted into a fixed number of ordinary shares on a fixed date or on the occurrence of an event which is certain to occur, should be classified as equity.

A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. The classification of this type of contract is dependent on whether there is variability in either the number of equity shares delivered or variability in the amount of cash or financial assets received. A contract which will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. However, if there is any variability in the amount of cash or own equity instruments which will be delivered or received, then such a contract is a financial asset or liability as applicable.

For example, where a contract requires the entity to deliver as many of the entity's own equity instruments as are equal in value to a certain amount of cash, the holder of the contract would be indifferent whether it received cash or shares to the value of that amount. Thus this contract would be treated as debt.

Other factors, which may result in an instrument being classified as debt, are:

- redemption is at the option of the instrument holder
- there is a limited life to the instrument
- redemption is triggered by a future uncertain event which is beyond the control of both the holder and issuer of the instrument
- dividends are non-discretionary

Similarly, other factors, which may result in the instrument being classified as equity, are whether the shares are non-redeemable, whether there is no liquidation date or where the dividends are discretionary.

(ii) The classification of a financial instrument by the issuer as either debt or equity can have a significant impact on the entity's gearing ratio, reported earnings, and debt covenants. Equity classification can avoid such impact but may be perceived negatively if it is seen as diluting existing equity interests. The distinction between debt and equity is also relevant where an entity issues financial instruments to raise funds to settle a business combination using cash or as part consideration in a business combination. Understanding the nature of the classification rules and potential effects is critical for management and must be borne in mind when evaluating alternative financing options. Liability classification normally results in any payments being treated as interest and charged to profit or loss, which may affect the entity's ability to pay dividends on its equity shares.

(b) Cavor

An obligation must be established through the terms and conditions of the financial instrument. IAS 32 uses principles-based definitions of a financial liability and of equity. IAS 32 uses substance over form as a principle to classify a financial instrument between equity and financial liability. IAS 32 restricts the role of 'substance' to consideration of the contractual terms of an instrument. Anything outside the contractual terms is not therefore relevant to the classification process under IAS 32. The B shares of Cavor should be classified as equity as there is no contractual obligation to pay the dividends or to call the instrument. Dividends can only be paid on the B shares if dividends have been declared on the A shares and they are payable at the same rate as the A shares which will be variable. There is no contractual obligation to declare A share dividends.

The classification of the B share options in Cavor is dependent on whether there is variability in either the number of equity shares delivered or variability in the amount of cash or financial assets received. As there is no variability and the contract will be settled by the entity issuing a fixed number of its own equity instruments in exchange for a fixed amount of cash, then the share options are classified as an equity instrument.

Lidan

The contractual obligation may arise from a requirement to repay principal or interest or dividends. Such a contractual obligation need not be explicit. It may instead be established indirectly through the terms and conditions of the financial instrument and the liability classification is not avoided by a share settlement alternative which is uneconomic in comparison to the cash obligation. The B shares of Lidan will be classified as a liability. This is because the value of the own share settlement alternative substantially exceeds that of the cash settlement option, meaning that the entity is implicitly obliged to redeem the option for a cash amount of $1 per share. Additionally, IAS 32 also states that where a derivative contract has settlement options, it is a financial asset or liability unless all of the settlement alternatives result in it being an equity instrument. This would also lead to the conclusion that the B shares are a financial liability.

			Marks
1	**(a)**	Impairment adjustment	4
		Nathan	6
		Option	6
		Inventory	1
		Share options	4
		PPE	3
		Employee benefits	4
		NCI	2
		Sale of equity interest in Nathan	5
			35
	(b)	1 mark per point up to maximum	9
	(c)	1 mark per point up to maximum	6
			50
2	**(a)**	1 mark per point up to maximum	7
	(b)	1 mark per point up to maximum	6
	(c)	1 mark per point up to maximum	5
	(d)	1 mark per point up to maximum	5
	Professional marks		2
			25
3	**(a)**	1 mark per point up to maximum	7
	(b)	1 mark per point up to maximum	5
	(c)	1 mark per point up to maximum	5
	(d)	1 mark per point up to maximum	6
	Professional marks		2
			25
4	**(a)**	**(i)** 1 mark per point up to maximum	9
		(ii) Effects	5
	(b)	1 mark per point up to maximum	9
		Professional marks	2
			25