Answers

1 (a) Diamond Group

Consolidated statement of financial position as at 31 March 2017

	$m
Assets	
Non-current assets	
Property, plant and equipment (W7)	3,590·9
Goodwill (W2)	79
Other financial assets (W8)	295
	3,964·9
Current assets (W9)	1,891
Total assets	5,855·9
Equity and liabilities	
Share capital of $1 each	1,650
Retained earnings (W12)	1,337·6
Other components of equity (W14)	135·8
	3,123·4
Non-controlling interest (W13)	697·5
Total equity	3,820·9
Non-current liabilities (W10)	1,501·5
Current liabilities (W11)	533·5
Total liabilities	2,035
Total equity and liabilities	5,855·9

Working 1 – Goodwill on acquisition of Spade

	$m	$m
Cash consideration		1,140
Non-controlling interest – fair value		485
		1,625
Fair value of identifiable net assets acquired:		
Share capital	720	
Retained earnings	780	
Other components of equity	64	
Fair value adjustment – land (W7)	36	
		(1,600)
Goodwill		25

Working 2 – Club

Diamond initially has equity accounted for its 40% interest in Club. This would have been accounted for as follows: (Note that the carrying amount of net assets at 31 March 2016 would be $1,052 million ($700m + $293m + $59m))

	$m
Cost of investment	420
Share of post-acquisition net assets (40% x ($1,052m – $1,032m)	8
	428

When purchasing the extra 45% the $500 million cash has been added, hence the investment in Club is $928 million in Diamond's financial statements. However, on obtaining control in Club, Diamond should have restated the value of its original 40% investment to fair value. The fair value is best estimated using the share price of Club and is calculated as (40% x $700 million x $1·60) = $448 million. The investment should have been debited with a further $20 million and credited to profit or loss (W12). Goodwill will be calculated as follows:

	$m	$m
Cash consideration		500
Fair value of original 40% interest		448
		948
Non-controlling interest (15% x 700 x $1·60)		168
		1,116
Fair value of identifiable net assets acquired:		
Share capital	700	
Retained earnings	293	
Other components of equity	59	
Fair value adjustment – plant (W7)	10	
		(1,062)
Goodwill		54

Total goodwill is therefore $79 million ($25m + $54m).

Additional depreciation will charged on the plant of $2 million ($10m/5) (W7).

Working 3 – Disposal of Heart

Diamond would originally have significant influence over Heart via its 25% holding. Diamond has equity accounted for Heart up to 31 March 2016 giving an equity value of $110 million. Diamond should have equity accounted right up to 30 September 2016, at which point significant influence is lost. A further $2·5 million (25% x $20m x 6/12) should have been added to the investment and included within retained earnings (W12).

On losing significant influence, a profit or loss on disposal should be calculated as follows:

	$m	
Proceeds	42	
Fair value of remaining interest at 30 September 2016	65	
	107	
Investment in associate at 30 September 2016 ($110m + $2·5m)	(112·5)	
Loss on disposal	(5·5)	(W12)

The remaining 15% holding is restated to fair value of $67 million at 31 March 2017 (W8). A gain is to be recorded in other components of equity of $2 million ($67m – $65m) (W15).

Working 4 – Bonds

The substance of the transaction appears to be that of a secured loan rather than a disposal of bonds. This is evidenced by the sale being below fair value and the fact that the repurchase price is also below expected fair value, such that the option is highly likely to be exercised. The proceeds of $35 million should therefore be treated as a current liability (it is repayable at any time) rather than as a disposal of the bonds.

At 31 March 2016, prior to the loss, the bonds had a carrying amount of $42 million. Interest received and taken to profit or loss (and retained earnings) is $3 million (6% x $50m). The carrying amount of the bonds should be restated to fair value of $38 million at 31 March 2017. A loss of $4 million should be recorded in other components of equity calculated as follows:

	$m
Balance at 31 March 2016	42
Interest income at effective rate of 6%	3
Less coupon rate of 6%	(3)
Loss to other components of equity	(4)
Balance at 31 March 2017	38

Tutorial note: *The following correcting entry is required to the financial statements of Diamond:*

	Dr	*Cr*
Other financial assets (W8)	*38*	
Other components of equity (W14)	*4*	
Loss on disposal (retained earnings) (W12)		*7*
Current liabilities (W11)		*35*

Working 5 – Pension adjustment

The estimated settlement on the pension liability is $7·5 million (150 x $50,000) and should be included within current liabilities (W11). As this is $1·7 million more than the estimated curtailment gain of $5·8 million, a loss of $1·7 million should be included within retained earnings (W12). Non-current liabilities are reduced by the reduction in pension obligations of $5·8 million (W10).

Working 6 – Leased manufacturing unit

The alteration costs of $6·6 million should be capitalised, and not charged as an expense. A provision for restoration costs of $3·3 million ($5m x 0·665) should also be recognised and capitalised as part of the carrying amount of the asset.

Adjustments required:

	$m
DR Property, plant and equipment (W7)	9·9
CR Retained earnings (W12)	6·6
CR Non-current liabilities (W11)	3·3

Working 7 – Property, plant and equipment

	$m
Diamond	1,062
Spade	1,210
Club	1,265
FV uplift Spade (W1)	36
FV uplift Club (10 – 2) (W2)	8
Capitalisation of unit alterations (W6)	9·9
	3,590·9

Working 8 – Other financial assets

	$m
Diamond	190
Investment in Heart (W3)	67
Fair value of bonds at 31 March 2017 (W4)	38
	295

Working 9 – Current assets

	$m
Diamond	885
Spade	782
Club	224
	1,891

Working 10 – Non-current liabilities

	$m
Diamond	1,143
Spade	189
Club	172
Curtailment (W5)	(5·8)
Obligation to restore unit (W6)	3·3
	1,501·5

Working 11 – Current liabilities

	$m
Diamond	172
Spade	125
Club	194
Loan (W4)	35
Past service cost accrual (W5)	7·5
	533·5

Working 12 – Retained earnings

	$m
Diamond	1,180
Gain on step acquisition of Club (W2)	20
Heart – share 6 months profit (W3)	2·5
Reverse loss on disposal of bonds (W4)	7
Loss on settlement pension (W5)	(1·7)
Incorrect expense building costs (W6)	6·6
Loss on disposal of Heart as associate (W3)	(5·5)
Share post acquisition Spade (70% x ($880m – $780m))	70
Share post acquisition Club (85% x (($364 – 2m (W2)) – $293m))	58·7
	1,337·6

Working 13 – Non-controlling interest

	$m
Spade at acquisition	485
Club at acquisition	168
Post-acquisition retained earnings – Spade (30% x ($880m – $780m))	30
Post-acquisition retained earnings – Club (15% x ($364 – 2m (W2) – $293m))	10·3
Post-acquisition other components of equity – Spade (30% x ($78m – $64m))	4·2
	697·5

Working 14 – Other components of equity

	$m
Diamond	128
Post-acquisition – Spade (70% x ($78m – $64m))	9·8
Fair value gain Heart (W3)	2
Fair value loss on bonds (W4)	(4)
	135·8

(b) The requirements in the Companies Act 2014 to prepare group accounts are largely mirrored in FRS 102, which states that consolidated financial statements (group accounts in the Companies Act) are prepared by all parent entities unless one of the following exemptions, which are derived from the Companies Act, applies:

(i) Exemptions on the basis of size, s.297 of the Companies Act 2014 are only available to private companies.

(ii) The parent company is a subsidiary included in a larger group which prepares consolidated financial statements and meets the requirements of sections 8 and 9 of the Group Accounts Regulations 1992, including:

(a) The parent is itself a subsidiary whose immediate parent is established in an EEA state, and whose results are consolidated into the group financial statements of an undertaking established in an EEA state (not necessarily the immediate parent). Section 8 sets out further conditions for this exemption, including that a company, which has any of its securities admitted to trading on a regulated market in an EEA state, is not eligible for this exemption.

(b) The parent is itself a subsidiary, its immediate parent is not established in an EEA state, and its results are consolidated into the group accounts of an undertaking (either the same parent or another) drawn up in accordance with the EU Seventh Directive or in an equivalent manner (for example, EU-IFRS accounts).

Section 8 sets out further conditions for this exemption, including that a company, which has any of its securities admitted to trading on a regulated market in an EEA state, is not eligible for this exemption.

(iii) All of the parent's subsidiaries are excluded from consolidation under FRS 102.

If an entity is not a parent at the year end, then it is not required to prepare consolidated accounts.

Exclusion of subsidiaries from consolidation

Consolidated financial statements provide information about the group as a single economic entity. They include all subsidiaries of the parent except those excluded on one of the following grounds:

(a) severe long-term restrictions substantially hinder the exercise of the rights of the parent over the assets or management of the subsidiary. These rights are the rights held by or attributed to the company in the absence of which it would not be the parent company; or

(b) the subsidiary is held exclusively for resale and has not previously been included in the consolidation.

A subsidiary excluded from consolidation due to severe long-term restrictions is, if the parent still exercises significant influence, equity accounted and treated as an associate. Otherwise, the parent has a choice of accounting policy to measure the subsidiary either at:

– cost less impairment, or
– at fair value through other comprehensive income (OCI) with movements below cost recorded in profit or loss or
– at fair value through profit or loss.

A subsidiary excluded from consolidation on the basis of not previously having been consolidated and being held exclusively for resale is accounted for in accordance with FRS 102, which gives a choice of accounting policy of either:

– cost less impairment,
– fair value through OCI with movements below cost recorded in profit or loss or
– fair value through profit or loss unless it is held as part of an investment portfolio.

If it is held as part of an investment portfolio, it is held at fair value through profit or loss.

Section 11 of the Group Accounts Regulations 1992 states that a subsidiary may be excluded from consolidation if the necessary information to prepare the group accounts cannot be obtained without disproportionate expense or undue delay. FRS 102, however, states that this does not justify non-consolidation, effectively closing off the statutory option. Subsidiaries are not excluded from consolidation because the subsidiary has dissimilar business activities to the rest of the group.

(c) It is of crucial importance that stakeholders of a company can rely on the financial statements in order to make informed and accurate decisions. The directors of Diamond have an ethical responsibility to produce financial statements which comply with accounting standards, are transparent and free from material error. Lenders will often attach covenants to the terms of an agreement in order to protect their interests in an entity. They would also be of crucial importance to potential debt and equity investors when assessing the risks and returns from any future investment in the entity.

The proposals by Diamond appear to be a deliberate attempt to circumvent the terms of the covenants. The legal form would be to net the proceeds from the receivables rather than to create a current liability. This would be a form of 'off balance sheet finance' should the substance be contrary to the legal form. It is likely that liquidity ratios would be adversely misrepresented from the proposed accounting treatment. Debt factoring is a normal activity for many entities and discounts are a necessary part of any agreement. They should not be disclosed separately. The impact on the operating profit margins would depend upon whether they were included above or below operating profit. It appears likely that Diamond is trying to maximise a 'normalised' level of operating profit by showing them separately after operating profits.

Diamond is aware that the proposed accounting treatment may be contrary to accounting standards. Such manipulation would be a clear breach of the fundamental principles of objectivity and integrity as outlined in the ACCA *Code of Ethics*. It is important that accountants are seen to exercise professional behaviour and due care at all times. The proposals by Diamond are likely to mislead stakeholders in the entity. This could discredit the profession creating a lack of confidence within the profession. Diamond must be reminded of its ethical responsibilities and persuaded that the accounting treatment must fully comply with accounting standards and principles outlined within the framework should they proceed with the debt factoring agreements.

2 (a) (i) IFRS 13 *Fair Value Measurement* defines fair value as the price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant who would use the asset in its highest and best use. The highest and best use of a non-financial asset takes into account the use of the asset which is physically possible, legally permissible and financially feasible. Due to the lack of an active market for identical assets, it would be rare for property to be classified in Level 1 of the fair value hierarchy. In market conditions where property is actively purchased and sold, the fair value measurement might be classified in Level 2. However, that determination will depend on the facts and circumstances, including the significance of adjustments to observable data. In this regard, IFRS 13 provides a property specific example, stating that a Level 2 input would be the price derived from observed transactions involving similar property interests in similar locations. Accordingly, in active and transparent markets, property valuations may be classified as Level 2, provided that no significant adjustments have been made to the observable data. If significant adjustments to observable data are required, the fair value measurement may fall into Level 3.

IAS 40 *Investment Property* permits entities to choose between a fair value model and a cost model. One method must be adopted for all of an entity's investment property. A change is permitted only if this results in a more appropriate presentation. IAS 40 notes that this makes it highly unlikely for a change from a fair value model to a cost model to occur. Transfers to or from investment property should only be made when there is a change in use, which is evidenced by the end of owner-occupation, which has occurred in this case. For a transfer from owner-occupied property to investment property carried at fair value, IAS 16 *Property, Plant and Equipment* (PPE) should be applied up to the date of reclassification. Any difference arising between the carrying amount under IAS 16 at that date and the fair value is dealt with as a revaluation under IAS 16.

The aggregate fair value of the site, including the industrial and retail units, is higher to market participants than the sum of the fair value of the individual property interests because of synergies and complementary cash flows.

Consequently, the fair value of the site as a whole would be maximised as a group of assets. The fair value is determined for the whole site even if the asset is disaggregated when applying IAS 40.

In some cases, it would not be appropriate to estimate fair value of mixed-use property interests as a group. In some instances when valuing property interests, fair value is maximised based on the price which would be received in a current transaction to sell the asset on a stand-alone basis.

Thus providing that the above criteria have been met, Canto may value the property at $25 million.

Canto will recognise a depreciation expense of $0·5 million in profit or loss in the year to 28 February 2017 while the property is accounted for using a cost model. At 28 February 2017, Canto will transfer the property from PPE to investment property at its carrying amount of $13·5 million ($15 million – depreciation of $1·5 million) and recognise the increase of $11·5 million in the fair value of the investment property in a revaluation surplus through other comprehensive income and as an increase in the value of the investment property.

(ii) IAS 36 *Impairment of Assets* requires that assets be carried at no more than their carrying amount. Therefore entities should test all assets within the scope of the standard if there is potential impairment when indicators of impairment exist. If fair value less costs of disposal or value in use is more than carrying amount, the asset is not impaired. It further says that in measuring value in use, the discount rate used should be the pre-tax rate which reflects current market assessments of the time value of money and the risks specific to the asset. The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return which investors would require if they were to choose an investment which would generate cash flows equivalent to those expected from the asset. Therefore pre-tax cash flows and pre-tax discount rates should be used to calculate value in use. Discounting post-tax cash flows with a post-tax discount rate could give the same result in an entity were it not for any temporary differences and/or tax losses which might exist.

Date year ended	Pre-tax cash flow ($m)	Discounted cash flows ($m) at 8%
28 February 2018	8	7·41
28 February 2019	7	6·00
29 February 2020	5	3·97
28 February 2021	3	2·21
28 February 2022	13	8·85
Total		28·44

The CGU is impaired by the amount by which the carrying amount of the cash-generating unit exceeds its recoverable amount which is the higher of an asset's fair value less costs of disposal and its value in use. The fair value less costs to sell ($26·6 million) is lower than the value in use ($28·44 million). The recoverable amount is therefore $28·44 million. The carrying amount is $32 million and therefore the impairment is $3·56 million.

Canto will allocate the impairment loss first to the goodwill and then to other assets of the unit pro rata on the basis of the carrying amount of each asset in the cash-generating unit. Consequently, the entity will allocate $3 million to goodwill and then allocate $0·56 million on a pro rata basis to PPE (0·56 x 10/29 = $0·19 million) and other assets (0·56 x 19/29 = $0·37 million). This would mean that the carrying amounts would be $9·81 million and $18·63 million respectively.

However, when allocating the impairment loss, the carrying amount of an asset cannot be reduced below its fair value less costs to sell. The fair value less costs to sell of the CGU's assets is $9·9 million (PPE) and $16·7 million (other assets). Therefore the carrying amounts of the assets of the CGU after impairment will be PPE $9·9 million and other assets $18·54 million as the excess impairment of $0·09 million on PPE will be allocated to other assets.

(b) IFRS for SMEs states that an entity should recognise an intangible asset as an asset if, and only if:

(i) It is probable that the expected future economic benefits which are attributable to the asset will flow to the entity;
(ii) the cost or value of the asset can be measured reliably; and
(iii) the asset does not result from expenditure incurred internally on an intangible item.

The social media site is an intangible asset of the entity. It is an asset of the entity because the entity has control through ownership of the website and expects to generate future economic benefits by selling advertising space on the site. Also the cost of setting up the site can be measured reliably.

In the absence of legal rights to protect the entity's relationships with its customers or to control the customers' loyalty, Bento is unlikely to have sufficient control over the expected economic benefits from its customer relationships to meet the definition of an intangible asset. Legal rights to protect customer relationships provide evidence that the entity is able to control the expected future economic benefits flowing from the customer relationships. When an entity establishes relationships with its customers through fixed-term contracts, and those contracts contain legally enforceable contractual rights to future revenue, the definition of an intangible asset will be met. However, internally generated intangible assets are not recognised but separately acquired customer lists may qualify for recognition. Although each domain name satisfies the definition of an intangible asset, the names are not classified as intangible assets of the entity. The domain names are inventories of the entity because they are assets held for sale in the ordinary course of business.

Under the IFRS for SMEs, an entity must recognise expenditure incurred internally on an intangible item, including all expenditure for both research and development activities, as an expense when it is incurred unless it forms part of the cost of another asset which meets the recognition criteria in the IFRS. Under FRS 102, internally generated intangible assets may be recognised if they constitute development costs.

Under the IFRS for SMEs, an entity must measure intangible assets after initial recognition at cost less any accumulated amortisation and any accumulated impairment losses. Under FRS 102, an entity may measure intangible assets after initial recognition using either the cost model or the revaluation model. Where the revaluation model is selected, this must be applied to all intangible assets in the same class. If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset must be carried at its cost less any accumulated amortisation and impairment losses.

3 **(a)** Under IAS 17 *Leases*, a lease is classified as a finance lease if it transfers substantially all of the risks and rewards incident to ownership. All other leases are classified as operating leases. 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 form.

In this case, the leases are operating leases. The lease is unlikely to transfer ownership of the vehicle to the lessee by the end of the lease term as the option to purchase the vehicle is at a price which is higher than fair value at the end of the lease term. The lease term is not for the major part of the economic life of the asset as vehicles normally have a length of life of more than three years and the maximum unpenalised mileage is 10,000 miles per annum. Additionally, the present value of the minimum lease payments is unlikely to be substantially all of the fair value of the leased asset as the price which the customer can purchase the vehicle is above market value, hence the lessor does not appear to have received an acceptable return by the end of the lease. Carsoon also stipulates the maximum mileage and type of usage, as the vehicles cannot be used in other jurisdictions. This would appear to indicate that the risks and rewards remain with Carsoon. Finally, Carsoon maintains the vehicles which again indicates that the risks and rewards remain with the entity.

Carsoon should account for vehicles held for rental as operating leases in property, plant and equipment (PPE) and depreciate them taking into account the expected residual value. The rental payments should go to profit or loss. Where an item of property, plant and equipment ceases to be rented and becomes held for sale, it should be transferred to inventory at its carrying amount. The proceeds from the sale of such assets should be recognised as revenue in accordance with IFRS 15 *Revenue from Contracts with Customers*. IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* does not apply when assets which are held for sale in the ordinary course of business are transferred to inventories.

IAS 7 *Statements of Cash Flows* states that payments from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events which enter into the determination of profit or loss. Therefore cash payments made to acquire assets formerly held for rental and subsequently held for sale should be treated as cash flows from operating activities and not investing activities.

(b) For financial assets which are debt instruments measured at fair value through other comprehensive income (FVOCI), both amortised cost and fair value information are relevant because debt instruments in this measurement category are held for both the collection of contractual cash flows and the realisation of fair values. Therefore, debt instruments measured at FVOCI are measured at fair value in the statement of financial position. In profit or loss, interest revenue is calculated using the effective interest rate method and impairment gains and losses are derived using the same method as for financial assets measured at amortised cost. The fair value gains and losses on these financial assets are recognised in other comprehensive income (OCI). As a result, the difference between the total change in fair value and the amounts recognised in profit or loss are shown in OCI. When these financial assets are derecognised, the cumulative gains and losses previously recognised in OCI are reclassified from equity to profit or loss. Expected credit losses (ECLs) do not reduce the carrying amount of the financial assets, which remains at fair value. Instead, an amount equal to the ECL allowance which would arise if the asset were measured at amortised cost is recognised in OCI.

The fair value of the debt instrument therefore needs to be ascertained at 28 February 2017. IFRS 13 *Fair Value Measurement* states that Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities which the entity can access at the measurement date. The standard sets out that adjustment to Level 1 prices should not be made except in certain circumstances. An entity may, as a practical expedient, measure fair value using an alternative pricing method which does not rely exclusively on quoted prices and this price would be within a lower level of the fair value hierarchy. In-house models are alternative pricing methods which do not rely exclusively on quoted prices. It would seem that a Level 1 input is available, based upon activity in the market and further that, because of the active market, there is no reason to use a 'practical expedient' to value the debt.

Therefore the accounting for the instrument should be as follows: The bonds will be initially recorded at $6 million and interest of $0·24 million will be received and credited to profit or loss. At 28 February 2017, the bonds will be valued at $5·3 million, which recognises 12-month credit losses and other reductions in fair value. The loss of $0·7 million will be charged as an impairment loss of $0·4 million to profit or loss and $0·3 million to OCI. When the bond is sold for $5·3 million on 1 March 2017, the financial asset is derecognised and the loss in OCI ($0·3 million) is reclassified to profit or loss. Also the fact that the bond is sold for $5·3 million on 1 March 2017 illustrates that this should have been the fair value on 28 February 2017.

(c) IFRS 15 *Revenue from Contracts with Customers* specifies how to account for costs incurred in fulfilling a contract which are not in the scope of another standard. Costs to fulfil a contract which is accounted for under IFRS 15 are divided into those which give rise to an asset and those which are expensed as incurred. Entities will recognise an asset when costs incurred to fulfil a contract meet certain criteria, one of which is that the costs are expected to be recovered.

For costs to meet the 'expected to be recovered' criterion, they need to be either explicitly reimbursable under the contract or reflected through the pricing of the contract and recoverable through the margin.

The penalty and additional costs attributable to the contract should be considered when they occur and Carsoon should have included them in the total costs of the contract in the period in which they had been notified.

As regards the counter claim for compensation, Carsoon accounts for the claim as a contract modification in accordance with IFRS 15. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, Carsoon should account for the modification by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation.

A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations which are created or changed by a modification are enforceable, an entity should consider all relevant facts and circumstances including the terms of the contract and other evidence. On the basis of information available, it is possible to feel that the counter claim had not reached an advanced stage, so that claims submitted to the client could not be included in total revenues.

When the contract is modified for the construction of the storage facility, an additional $7 million is added to the consideration which Carsoon will receive. The additional $7 million reflects the stand-alone selling price of the contract modification. The construction of the separate storage facility is a distinct performance obligation; the contract modification for the additional storage facility would be, in effect, a new contract which does not affect the accounting for the existing contract. Therefore the contract is a performance obligation which has been satisfied as assets are only recognised in relation to satisfying future performance obligations. General and administrative costs cannot be capitalised unless these costs are specifically chargeable to the customer under the contract. Similarly, wasted material costs are expensed where they are not chargeable to the customer. Therefore a total expense of $15 million will be charged to profit or loss and not shown as assets.

4 (a) (i) The preparers of financial statements have to deal with the uncertainties which surround the preparation of financial statements. For example, events such as the collectability of doubtful receivables and the probable useful life of plant and equipment have a degree of uncertainty attached to them. Such uncertainties are recognised by the disclosure and by the exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow for deliberate understatement or deliberate overstatement because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Prudence is a term used by different people to mean different things. Some use it to refer to a need to be more cautious when making judgements relating to gains and assets than for those relating to losses and liabilities. Others feel that losses should be recognised at an earlier stage than gains. Faithful representation requires that financial statements are neutral and so an understanding of prudence is linked to an understanding of the term 'neutrality'.

The arguments put forward against the reintroduction of prudence into the *Conceptual Framework* include the fact that there is no common understanding of what prudence means and thus there are different interpretations as to its meaning. This could lead to inconsistent application of the concept.

The exercise of prudence can lead to greater subjectivity in the financial statements, which will affect the evaluation of the entity's performance.

However, the opposite view is that a reference to prudence should be reinstated in the *Conceptual Framework*. Certain Standards are underpinned by the concept of prudence and therefore it is important to explain prudence in the *Conceptual Framework* so that it can be applied consistently. Preparers of financial statements have a natural bias towards optimism and therefore prudence is needed to counteract this bias. Investors are often more concerned with the financial risk relating to potential losses. There are views that some form of conservatism has a role to play in financial reporting even though there are different views about what form this would take. Additionally, the financial crisis has demonstrated the need for prudence when making estimates.

(ii) The existing *Conceptual Framework* does not include an explicit reference to substance over form. However, accounting in accordance with an element's legal form, and not its economic substance, would not result in a faithful representation. The Exposure Draft proposes that a faithful representation should provide information about the substance of an economic phenomenon instead of merely information about its legal form. Accounting for something in accordance with its legal form, even with appropriate disclosures, cannot result in a faithful representation if the economic substance of the item is different.

The existing *Conceptual Framework* does not define derecognition, nor does it describe when derecognition should occur. As a result, different standards have adopted different approaches to derecognition. The derecognition criteria need to reflect how best to portray both an entity's rights and obligations and changes in those rights and obligations. The accounting requirements for derecognition should aim to represent faithfully the assets and the liabilities retained after the derecognition and the changes in the assets and the liabilities as a result of the transaction or event. If an entity disposes of an entire asset or an entire liability and retains no exposure to that asset or liability, then normally there is no issue, but it can be more difficult if an entity disposes of only part of an asset or a liability. In most cases, an entity will achieve the best result if it applies the control approach, that is by derecognising an asset or a liability when it no longer meets the recognition criteria.

(b) **(i)** IAS 32 *Financial Instruments: Presentation* states that a liability is a contractual obligation to deliver cash or another financial asset to another entity and that equity is any contract which evidences a residual interest in the assets of an entity after deducting all of its liabilities. In this case, Skye has no obligation to transfer cash or another asset to the holders of the instruments and therefore the B shares should be classed as equity. The fact that Skye has not refused redemption in the past does not cause the B shares to be classified as a liability.

The preference shares create an obligation for Skye because of the put option clause in the agreement. The fact that Skye may not be in a position to satisfy the put option feature because of insufficient distributable reserves does not negate the fact that Skye has an obligation.

(ii) The ED *Conceptual Framework* says that a liability is a present obligation of the entity to transfer an economic resource as a result of past events. A present obligation is an obligation to transfer economic resources which the entity has no practical ability to avoid and has arisen from a past event, that is, economic benefits already received or activities already conducted. The future sales-linked compensation is a mechanism for determining the amount of past and future use of the intellectual property. Therefore because part of the settlement is a variable amount to pay for past usage (even though this is based on future sales) Skye should recognise a financial liability under IFRS 9 at 31 May 2017. It is a present obligation as a result of a past event and this principle is the basis of the definition of a liability not only in the ED but also in the existing *Conceptual Framework*. As regards the sales-linked payment relating to future use, the liability arises as new sales are realised and represents an executory contract under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In these circumstances, Skye should not recognise a liability as the variable amount is based upon future sales, unless the executory contract is deemed to be onerous.

				Marks
1	**(a)**	Property, plant and equipment		3
		Goodwill Spade		2
		Goodwill Club		3
		Disposal Heart		3
		Other financial assets		5
		Pension and provision		4
		Current liabilities		2
		Retained earnings		6
		Non-controlling interest		4
		Other components of equity		3
				35
	(b)	1 mark per point up to maximum		9
	(c)	1 mark per point up to maximum		6
				50
2	**(a)**	**(i)**	1 mark per point up to maximum	8
		(ii)	1 mark per point up to maximum	8
	(b)	1 mark per point up to maximum		7
	Professional marks			2
				25
3	**(a)**	1 mark per point up to maximum		8
	(b)	1 mark per point up to maximum		8
	(c)	1 mark per point up to maximum		7
	Professional marks			2
				25
4	**(a)**	**(i)**	1 mark per point up to maximum	6
		(ii)	1 mark per point up to maximum	8
	(b)	**(i)**	1 mark per point up to maximum	5
		(ii)	1 mark per point up to maximum	4
	Professional marks			2
				25