
Answers

1 (a) Consolidated balance sheet of Alpha at 31 March 2006

	\$'000
Assets	
Non-current assets:	
Property, plant and equipment (90,000 + 80,000 + 20,000 (W2) + 3,000 (W2))	193,000
Goodwill (W3)	20,588
Other intangible assets (W2)	8,000
Available for sale investments (W1)	16,000
	237,588
Current assets:	
Inventories (30,000) + 28,000 – 3,000)	55,000
Trade receivables (35,000 + 25,000 – 5,000)	55,000
Other current assets (4,000 + 3,000)	7,000
Cash and cash equivalents (10,000 + 9,000 + 5,000)	24,000
	141,000
Total assets	378,588
Equity and Liabilities	
Equity attributable to equity holders of the parent	
Share capital	100,000
Other reserves (W1)	2,000
Retained earnings (W5)	62,775
	164,775
Minority interest (W4)	27,063
Total equity	191,838
Non-current liabilities:	
Long-term borrowings (50,000 + 24,000)	74,000
Deferred tax (36,000 + 13,000 + 7,750 (W6))	56,750
Total non-current liabilities	130,750
Current liabilities:	
Trade and other payables (18,000 + 13,000))	31,000
Short-term borrowings 6,000 + 4,000)	10,000
Current tax payable (9,000 + 6,000)	15,000
Total current liabilities	56,000
Total equity and liabilities	378,588

Workings – Unless Stated all Figures in \$'000

Working 1 – Group structure

- (i) Alpha owns 75% of the equity shares of Beta and this gives Alpha control over the operating and financial policies of Beta. Therefore under the provisions of IAS 27 – *Consolidated and Separate Financial Statements* – Alpha will consolidate Beta as a subsidiary.
- (ii) Alpha owns 16.67% of the equity shares of Gamma. Since no control or significant influence is present Gamma is not consolidated. Under the provisions of IAS 39 – *Financial Instruments: Recognition and Measurement* – the investment in Gamma is an available for sale financial asset. Such investments are valued at fair value, with gains or losses taken to equity. In this case the investment is valued at \$16 million (10 million x \$1.60) and the gain of \$2 million (10 million x (\$1.60 – \$1.40)) is taken to equity.

Working 2 – Net assets table (Beta)

	Acquisition Date	Balance sheet Date
Share capital	60,000	60,000
Retained earnings:		
Per accounts of Beta	15,000	25,000
Land adjustment	20,000	20,000
Plant and equipment adjustment	9,000	3,000
Inventories adjustment	1,000	–
Contingencies adjustment	(600)	–
Brand adjustment	10,000	8,000
Deferred tax on temporary differences (W6)	(9,850)	(7,750)
Net assets for the consolidation	104,550	108,250

Working 3 – Goodwill on consolidation of Beta

Cost of investment (45 million x \$2.20)	99,000
Share of net assets at date of acquisition (75% x 104,550 (W2))	(78,412)
So goodwill equals	20,588

Working 4 – Minority interest

25% x 108,250 (W2)	27,063
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Working 5 – Retained earnings

Alpha	63,000
Beta (75% (108,250 – 104,550))	2,775
Unrealised profit in inventories	(3,000)
	62,775

Working 6 – Deferred tax on temporary differences

	Acquisition Date	Balance sheet Date
Fair value adjustments:		
Land	20,000	20,000
Plant and equipment	9,000	3,000
Inventories	1,000	–
Contingency	(600)	–
Brand	10,000	8,000
	39,400	31,000
Deferred tax at 25%	9,850	7,750

- (b) If Alpha had representation on the board of Gamma and the ability to participate in its policy decisions then this would be likely to give Alpha significant influence over Gamma. Under the provisions of IAS 28 – *Investments in Associates* – this would make Gamma an associate of Alpha since it is not a subsidiary or a joint venture. Although significant influence is normally evidenced by the ownership of 20% or more of the equity of the relevant entity this need not always be the case so the fact that the ownership of shares in Gamma only constitutes a 16.67% holding does not preclude it from being designated as an associate.

Under IAS 28 associates are included in the consolidated financial statements under the equity method. The equity method initially records the investment at cost (net assets at acquisition plus related goodwill) but subsequently adjusts it for the post-acquisition change in the net assets of the relevant entity. Therefore the consolidated balance sheet effectively includes the investment in the associate at the share of net assets at the balance sheet date plus related goodwill on acquisition.

2 (a) Income statement of Delta for the year ended 31 March 2006

	\$'000
Revenue (W1)	221,000
Cost of sales (W3)	(149,250)
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Gross profit	71,750
Distribution costs (W3)	(15,750)
Administrative expenses (W3)	(31,500)
Finance costs (W5)	(5,500)
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Profit before tax	19,000
Income tax expense (W6)	(9,000)
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Profit for the period	10,000
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(b) Statement of changes in equity of Delta for the year ended 31 March 2006

	Share Capital \$'000	Other Reserves \$'000	Retained Earnings \$'000	Total \$'000
Balance at 31 March 2005	90,000	–	40,000	130,000
Profit for the period			10,000	10,000
Dividend paid			(20,000)	(20,000)
Equity element of convertible bond (W7)		2,000		2,000
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Balance at 31 March 2006	90,000	2,000	30,000	122,000
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(c) Balance sheet of Delta as at 31 March 2006

	\$'000
Assets	
Non-current assets	
Property, plant and equipment (W8)	66,500
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	66,500
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Current assets	
Inventories (35,000 + 5,000 (W1))	40,000
Trade receivables	50,000
Other current assets (W4)	9,000
Cash and cash equivalents	48,000
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	147,000
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Total assets	213,500
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Equity and Liabilities	\$'000
Equity	
Share capital	90,000
Other reserves	2,000
Retained earnings	30,000
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Total equity	122,000
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Non-current liabilities	
Long-term borrowings (W9)	51,000
Deferred tax (7,000 + 2,000)	9,000
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Total non-current liabilities	60,000
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Current liabilities	
Trade payables	15,000
Short-term borrowings (W1)	10,500
Current tax payable	6,000
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Total current liabilities	31,500
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Total equity and liabilities	213,500
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Workings – Unless Stated all Figures in \$'000**Working 1 – Revenue**

The 'sale' of goods on 1 March is a sale and repurchase transaction. Under the principle of IAS 18 – *Revenue* – such transactions should be treated as financing transactions where the seller has retained the risks and rewards of ownership. Given the existence of call and put options for Delta and the buyer then Delta has retained the risks and rewards of ownership and the following adjustments should be made:

- Reduce revenue by \$10 million.
- Increase short-term borrowings by \$10 million.
- Increase cost of sales and closing inventories by \$5 million.
- Provide for an appropriate finance cost, in this case \$500,000 ($\frac{1}{2} \times (\$11 \text{ million} - \$10 \text{ million})$). This finance cost is credited to trade payables to give a final addition of \$10.5 million.

Therefore the corrected revenue figure is:

Per trial balance	215,000
Remove revenue as stated above	(10,000)
Add 40% of revenue on construction contract	16,000
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	221,000
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Working 2 – Depreciation – excluding construction contract

Property	500
Plant and equipment (20% x (40,000 – 10,000))	6,000
Loss on sale of plant and equipment	1,000
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(New book value of sold item 2,000, proceeds 1,000)	7,500
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Working 3 – operating costs

	Cost of Sales	Distribution Costs	Administration Expenses
Per trial balance	–	15,000	30,000
Opening inventories	30,000		
Raw material purchases	90,000		
Production costs	50,000		
Closing inventories (35,000 + 5,000 (W1))	(40,000)		
Depreciation (W2)	5,250	750	1,500
Re: construction contract (W4)	14,000		
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To income statement	149,250	15,750	31,500
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Working 4 – construction contract

- The overall revenue is \$40 million.
- The overall predicted costs are \$10 million + \$8 million + \$6 million + \$4 million + \$7 million = \$35 million.
- 40% of each is taken to income.
- Costs incurred to date are \$10 million x $\frac{1}{2}$ + \$8 million + \$6 million = \$19 million.
- Attributable profit is 40% (\$40 million – \$35 million) = \$2 million.
- Progress payments are \$12 million.
- So the gross amount due from customers in the balance sheet is \$19 million + \$2 million – \$12 million = **\$9 million**.

Working 5 – Finance Costs

– Interest on long-term borrowing	4,000
– Relating to zero-interest bond (10% x 10,000)	1,000
– On effective financing transaction (W1)	500
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	5,500
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Working 6 – income tax expense

This year's estimate	6,000
Last year's under-provision	1,000
Transfer to deferred tax	2,000
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	9,000
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Working 7 – Equity element of convertible bond

Total proceeds	12,000
Loan element	(10,000)
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So equity element	2,000
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Working 8 – Property, plant and equipment

As per Trial balance:	
– Cost	100,000
– Accumulated depreciation	(30,000)
Written down value of disposal (W2)	(2,000)
Charge for depreciation for the year excluding specialist Plant (W2)	(6,500)
Written down value of specialist plant (\$10 million x 1/2)	5,000
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	66,500
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Working 9 – Long term borrowings

As per Trial balance	40,000
Debt portion of zero-coupon bond	10,000
Finance cost for current year	1,000
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	51,000
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3 Reply to issues raised by trainee

- (a) All listed companies located within the European Union that prepare consolidated financial statements are now required to use international financial reporting standards (IFRSs). This requirement applies to accounting periods beginning on or after 1 January 2005 so for our company the first full set of financial statements that is affected is the year ended 31 March 2006. The move to IFRSs does not imply that our own domestic standards are defective. It simply reflects the reality that standard setting is now an international endeavour. There is an increasing realisation that stakeholders will benefit from a financial reporting regime that is consistent across the world. As business adopts an increasingly global focus it becomes more and more important that financial reports are prepared using a consistent framework. Use of a consistent framework would also ease access to international capital markets, which is sometimes made costly at present because of the need in some jurisdictions for foreign companies to restate their financial statements in accordance with local standards in order to access the market.

IFRS 1 – *First-time Adoption of International Financial Reporting Standards* – applies to the first set of financial statements that purport to comply with IFRSs. IFRS 1 requires full comparatives in IFRS format and therefore we will need an opening IFRS balance sheet on 1 April 2004, the first day of the comparative period. Basically IFRS 1 requires a reconciliation between all statements previously reported under local GAAP that are now being presented under IFRSs. This means that the following reconciliations are required:

- Equity at 1 April 2004.
- Profit for the year ended 31 March 2005.
- Equity at 31 March 2005.

- (b) The reason why intangible assets relating to the newly acquired subsidiary appear in the consolidated balance sheet but not the balance sheet of the individual subsidiary is because the recognition criteria for internally developed intangibles at entity level are more stringent than those that arise when an asset is acquired as part of a business combination. IAS 38 – *Intangible Assets* – states that before an intangible can be recognised it must be identifiable. An identifiable intangible is one that is:

- Separable; or
- Arises from contractual or other legal rights, whether or not the asset is separable.

IAS 38 states that most intangibles acquired as part of a business combination will satisfy the ‘separability’ criteria and can be recognised provided a fair value can be determined reliably. However, the only internally developed intangibles that can be recognised separately at entity level are in-process development projects that satisfy stringent criteria.

- (c) The errors made in counting the inventories in previous years satisfy the definition of ‘prior period error’ given in IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors*. Prior period errors are omissions from, or misstatements in, the financial statements relating to the misuse of information that was available when the financial statements were authorised for issue and could have been reasonably expected to be used in the preparation of the financial statements. Under IAS 8 such errors are accounted for retrospectively, which means reworking the prior year figures after correcting the error, and reporting the difference in the statement of changes in equity (or statement of recognised income and expense if presented). On the other hand the estimate of the useful life of PPE is an accounting estimate which is not an ‘error’ and is accounted for prospectively under IAS 8. Therefore the whole impact is felt in the income statements of the current and future periods.

- (d) The granting of share options to employees is an example of share-based payment as defined in IFRS – *Share-based payment*. The fact that the award to the employees is not in cash does not affect the basic fact that the company has transferred value to its employees. A key principle underlying IFRS 2 is that there should be a charge to the income statement whether the payment is cash or share-based. Where the payment is in the form of shares or share options then IFRS 2 requires that the charge be measured as the market value of the relevant instruments on the date they are issued. The charge of \$1.80 per share implies that on 1 April 2005 the market value of an option to buy a share for \$10 on 31 December 2005 was \$1.80 per share. The market value is derived from a number of different factors, including expected changes in the actual share price.

4 (a) – reply to assistant

My response to your suggestion depends on the terms and conditions of the leases you are proposing. Accounting for leases is governed by the provisions of IAS 17 – *Leases*. For accounting purposes, IAS 17 classifies leases into two types, finance leases and operating leases.

A finance lease is one that, at the commencement of the lease, transfers substantially all of the risks and rewards incidental to the ownership of the asset from the lessor (the **legal** owner) to the lessee (the user). IAS 17 states that it is necessary to consider the substance of the lease agreement to determine whether such a transfer has in fact taken place. However IAS 17 does give examples of situations that, individually or in combination would normally lead to a lease being classified as a finance lease:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.
- The lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- The leased assets are of such a specialised nature that only the lessee can use them without major modifications.
- Where the lease is cancellable, any losses of the lessor associated with the cancellation are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the leased asset at the end of the lease term accrue to the lessee.
- The lessee has the ability to continue to lease the asset for a secondary period at a rent that is substantially lower than market rent.

Finance leases are accounted for in accordance with their substance, which is the outright purchase of the asset by the lessee using ‘borrowings’ provided by the lessor. The initial amount included in each of property, plant and equipment and borrowings is the fair value of the asset at the inception of the lease or, if lower, the present value of the minimum lease payments. Therefore if the leases you propose were classified as finance leases, the proposal would not have the desired effect.

Any lease that is not classified as a finance lease is classified as an operating lease. Such leases do not transfer the risks and rewards of ownership to the lessee so no asset or related borrowings appears on the balance sheet of the lessee. If the leases were classified in this manner then the proposal would achieve the desired effect.

(b) – extracts from financial statements

1. Fleet of vehicles

The lease appears to be an operating lease. It is for only half of the anticipated useful economic life of the vehicles and responsibility for repair and maintenance remains with the lessor. Therefore it is unlikely that Omega has assumed the risks and rewards of ownership.

The implication of classification as an operating lease is that the rentals will be charged by Omega against income as an operating expense over the lease term. The pattern of the charge will depend on the pattern of the benefits Omega receives from using the fleet, but usually the charge would be made on a straight-line basis. Thus \$180,000 would be charged to the income statement in the first year of the lease. No asset or liability would appear in the balance sheet (other than accrued or prepaid rent).

2. New production plant

This lease appears to be a finance lease. The lease term is six-years (because it is almost certain that Delta will contract to lease the asset for the secondary period) which is equal to the useful life of the asset. At the end of this second period, the useful economic life of the asset is expected to be negligible. The present value of the minimum lease payments is:

$$\frac{\$760,000}{(1.10)} + \frac{\$760,000}{(1.10)^2} + \frac{\$760,000}{(1.10)^3} + \frac{\$760,000}{(1.10)^4}$$

Which is approximately equal to \$2.4 million, the fair value of the asset. The income statement will show depreciation as an operating expense. The asset will be depreciated over six years, which is both the lease term and the useful economic life of the asset. Therefore (assuming a straight line basis of depreciation) the annual depreciation will be \$400,000. The income statement will also show a finance cost of \$240,000, being the ‘interest’ on the effective borrowing of \$2.4 million at 10%.

The balance sheet will show property, plant and equipment at a depreciated cost of \$2 million (\$2.4 million – £400,000). The effective borrowing will be shown as a liability, split between current and non-current liabilities. In order to compute the split, it is necessary to 'profile' the effective loan for the first two years as shown below:

Year	Opening Balance \$'000	Finance Cost \$'000	Cash Paid \$'000	Closing Balance \$'000
1	2,400	240	(760)	1,880
2	1,880	188	(760)	1,308

Therefore the total liability at the end of year 1 is \$1,880,000, of which \$1,308,000 is non-current and \$572,000 (\$1,880,000 – \$1,308,000) current.

(c) – property leases

A key issue for both options is whether the leases are classified as finance leases or operating leases. IAS 17 requires that the land and buildings elements of a property lease are considered separately for the purposes of lease classification. If title to the property is expected to pass by the end of the lease term (as with option (i) in this case) then both elements are classified as finance leases, with the fair value of the property at the inception of the lease being recognised as an asset and a liability.

The situation is more complex if title is not expected to pass (as with option (ii) in this case). Since land normally has an indefinite useful economic life then unless title passes it is not usually possible to claim that the risks and rewards of ownership of the land have been transferred to the lessee. Therefore the 'land element' is treated as an operating lease. Separate consideration then needs to be given to the buildings element. The buildings element will be treated as finance or operating depending on the facts of the case. If, as in this scenario, the buildings are expected to have little or no usefulness at the end of the lease term then this part of the lease will probably be classified as a finance lease.

5 Transaction 1

Cost of investment	\$'m
Market value of shares issued (100 million x 3/2 x \$10)	1,500
Present value of contingent consideration (100 million x \$1.21/(1.1) ²)	100
Incremental issue costs other than the issue cost of shares	1
Total	1,601

Comments – all refer to IFRS 3 – Business Combinations

- Shares issued are recorded at their market value at the date of issue.
- Contingent consideration is recognised in full if payment is probable. Where material, future consideration is measured at the present value of the cash payable.
- Incremental costs associated with the acquisition, other than the issue costs of financial instruments, can be included in the cost of the investment.

Fair value of identifiable net assets at the date of acquisition	\$'m
As in Kappa's balance sheet	1,200
Fair value of customer relationships	100
Total	1,300

Comments

Under IAS 38 – *Intangible Assets* – intangible assets can be recognised separately from goodwill provided they are identifiable, are under the control of the acquiring entity, and their fair value can be measured reliably. Customer relationships that are similar in nature to those previously traded pass these tests but employee relationships fail the 'control' test.

Calculation of goodwill	\$'m
Fair value of consideration given	1,601
Fair value of net assets acquired	(1,300)
So goodwill on acquisition equals	301

Comments

Under IFRS 3 goodwill is not written down unless impairment is evident.

Transaction 2

Under the provisions of IAS 32 – *Financial Instruments: Disclosure and Presentation* – the loan is a complex financial instrument that is classified partly as equity and part as a liability. The liability element of the instrument is more easily measurable as the present value of the future cash payments discounted at 10%, the finance cost of a non-convertible loan. Therefore in this case we would have:

$\$40 \text{ million} \times 3.17 + \$500 \text{ million} \times 0.683 = \468.3 million . The equity element would be the difference between \$500 million and \$468.3 million = \$31.7 million. This would be displayed as a separate element of equity and its carrying value would not change.

In order to compute the closing liability element it is necessary to profile the loan as shown below:

Year to 31 March	Opening Balance \$'000	Finance Cost \$'000	Cash Paid \$'000	Closing Balance \$'000
2006	468,300	46,830	(40,000)	475,130

The closing liability at 31 March 2006 is \$475.13 million – all in non-current liabilities.

Transaction 3

Both equity investment and the currency contract are financial instruments as defined in IAS 32 – *Financial Instruments: Presentation and Disclosure*. Key issues here are whether the financial instruments should be recognised and if so how they should be measured in the balance sheet and how any changes in carrying value should be reported. These matters are considered in IAS 39 – *Financial Instruments: Recognition and Measurement*.

IAS 39 states that an entity should recognise a financial instrument when and only when it becomes party to the contractual provisions of the instrument. Therefore the equity investment will not be recognised in the 2006 financial statements but the contract to purchase currency will be recognised from 31 January 2006.

The financial instrument that is recognised as a consequence of the currency transaction is a derivative financial instrument that is an effective hedge of a foreign currency transaction and so would be dealt with under the hedge accounting provisions of IAS 39. This means that the derivative is carried at fair value in the balance sheet (\$1.5 million). The treatment of the value change in the performance statements depends on whether the derivative is designated as a fair value hedge or a cash flow hedge (either designation is possible under IAS 39 where the hedge is of a foreign currency commitment).

- If the hedge is designated a fair value hedge then the gain is recognised in the income statement
- If the hedge is designated a cash flow hedge and is effective then the gain is recognised in equity.

		<i>Marks</i>
1	(a)	
	Conclude Beta a subsidiary	1
	Conclude on treatment of Gamma	2
	Principle line by line consolidate Beta but not Gamma	1
	Basic principle of W2	1
	Fair value adjustments (1 each)	5
	W3	2
	W4	1
	W5	2
	W6	2
	Basic aggregation work – up to	3
	Eliminate URP on inventory	1
	Eliminate intra-group receivable	1
	Include cash in transit	1
	Share capital is Alpha only	1
	Total for part (a) – maximum 21	24
	(b)	
	Identify significant influence present	1
	Comment on 20% issue	1
	So conclude associate	1
	Identify equity method and describe	2
	Total for part (b) – maximum 4	5
	Total for Question 1	25
2	(a)	
	Revenue	3
	Operating costs	6
	Finance costs	2
	Tax charge	2
	Total for part (a) – maximum 11	13
	(b)	
	Opening balances	1
	Profit for period	1
	Dividend	1
	Equity element of bond	1
	Total for part (b) – maximum 3	4
	(c)	
	PPE	3
	Inventory	2
	Construction contract	2
	Trade receivables	1/2
	Cash	1/2
	Equity as per SOCE	1
	Long-term borrowings	2
	Deferred tax	1
	Trade payables	1/2
	Tax payable	1/2
	Total for part (c) – maximum 11	13
	Total for Question 2	25

	Marks
3 (a) Explain EU regulation re: IFRS	1
Comment re: domestic standards	2
Comment re: desirability of harmonisation	2
Explain IFRS 1 applying to first time adopters	2
Explain need for reconciliations and detail	3
Total for part (a) – maximum 8	10
(b) Appreciate difference between internally developed and acquired intangibles	1
Comment IAS criteria for acquired intangibles – including specific conclusion	3
State position re: internally acquired intangibles	2
Total for part (b) – maximum 5	6
(c) Note inventory an ‘error’ under IAS 8	2
So apply retrospectively	2
Note depreciation an accounting estimate	1
So apply prospectively	2
Total for part (c) – maximum 5	7
(d) Explain basic principle of share-based payment (up to)	2
Charge to income based on market values	2
Explain charge to income of \$440,000	4
Total for part (d) – maximum 7	8
Total for Question 3	25
4 (a) General recognition of IAS 17	1
Appreciate distinction between finance and operating leases	1
General definition of finance lease	1
Discussion of typical characteristics (up to)	3
Explain accounting for finance leases	2
Definition of operating leases	1
Accounting for operating leases	1
Total for part (a) – maximum 7	10
(b) Conclude vehicle lease an operating lease	1
So identify accounting in IS and BS	2
Conclude lease of machines a finance lease (up to)	3
State depreciation in IS (with amount)	2
State PPE in BS (with amount)	2
State finance cost in IS (with amount)	2
Principle liability in BS	1
Principle need to split into current and non-current	1
Workings for split	2
Total for part (b) – maximum 12	16
(c) Discussion of option (i) – up to	3
Discussion of option (ii) – up to	5
Total for part (c) – maximum 6	8
Total for Question 4	25

	Marks
5 (a) Shares issued (with comment)	2
Contingent consideration (with comment)	3
Issue costs (with comment)	2
Intangible assets (with comment)	3
Goodwill calculation (with comment)	2
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Total for transaction 1 – maximum 9	12
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(b) Appreciate and comment on split presentation	2
Compute debt element	3
So equity element is balance	2
Compute and classify closing liability	3
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Total for transaction 2 – maximum 8	10
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(c) No recognition of investment	2
But derivative is recognised	2
Derivative measured at fair value	1
But qualifies as effective hedge	2
Can be fair value or cash flow hedge	2
Taken to income or equity depending on classification	2
	<hr/>
Total for transaction 3 – maximum 8	11
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Total for Question 5	25
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