Answers

1 (a) Robby Consolidated Statement of Financial Position at 31 May 2012

	$m
Assets	
Non-current assets:	
Property, plant and equipment (W8)	241·13
Goodwill (5 + 1) (W1 and W2)	6·00
Financial assets	29·00
Current assets (W9)	36·00
Total assets	312·13
Equity and Liabilities	
Ordinary shares	25·00
Other components of equity (W3)	2·00
Retained earnings (W3)	81·45
	108·45
Non-controlling interest (W4)	27·64
Total equity	136·09
Non-current liabilities including provision (W11)	94·84
Current liabilities (W10)	81·20
Total equity and liabilities	312·13

Working 1

Hail

	$m
Fair value of consideration for 80% interest	50·00
Fair value of non-controlling interest	15·00
	65·00
Fair value of identifiable net assets acquired	(60·00)
Goodwill	5·00

On consolidation, there will be a reversal of the fair value adjustments to the investment held at fair value through profit and loss. Further, the dividend income on investment should be taken to profit or loss and not other comprehensive income. Therefore the adjustments required are:

Dr Other comprehensive income	5·00
Cr Investment in Hail	5·00
Dr Other comprehensive income	2·00
Cr Retained earnings	2·00

Working 2

Zinc

	$m
Consideration: at 1 June 2009	2·00
at 1 June 2011	16·00
Increase in fair value to 31 May 2011	1·00
Investment in Zinc in Robby's financial statements	19·00
Increase in fair value of equity interest (5·00 – 2·00 – 1·00)	2·00
Fair value of consideration	21·00
Fair value of non-controlling interest	9·00
	30·00
Fair value of identifiable net assets	(26·00)
Increase in value	(3·00)
Goodwill	1·00

Working 3

Retained earnings

	$m
Robby:	
Balance at 31 May 2012	70·00
Dividend from Hail	2·00
Increase in fair value of equity interest – Zinc	2·00
Post-acquisition reserves: Hail	8·80
Zinc	2·16
Joint operation	0·68
Impairment loss	(0·70)
Transfer from OCE	0·11
Factoring trade receivables	0·40
Reversal of disposal profit on land under option	(4·00)
	81·45
Hail:	
Group reserves – 80% of 11	8·80
NCI – 20% of 11	2·20
Post-acquisition reserves (27 – 16)	11·00
Zinc:	
Post-acquisition reserves (19 – 15)	4·00
Less increase in depreciation (W2)	(0·40)
	3·60
Group reserves – 60% of 3·60	2·16
NCI – 40% of 3·60	1·44
	3·60

Other components of equity

	$m
Robby:	
Balance at 31 May 2012	11·00
Dividend to retained earnings	(2·00)
Profit on revaluation of investment in Hail	(5·00)
Impairment loss	(1·89)
Transfer to retained earnings	(0·11)
	2·00

Working 4

Non-controlling interest

	$m
Hail:	
At acquisition	15·00
Post-acquisition share	2·20
	17·20
Zinc:	
At acquisition	9·00
Post-acquisition share	1·44
	10·44
Total	27·64

Working 5

Trade receivables

Robby has transferred its rights to receive cash flows and its maximum exposure is to repay $3·6 million. This is unlikely, but Robby has guaranteed that it will compensate the bank for all credit losses. Additionally, Robby receives the benefit of amounts received above $3·6 million and therefore retains both the credit risk and late payment risk. Substantially, all the risks and rewards remain with Robby and therefore the receivables should still be recognised.

The correcting double entry is:

	$m
DR Trade receivables	4·00
CR Secured borrowings	3·60
CR Retained earnings	0·40

Working 6

Impairment of PPE

Any impairment loss on a revalued asset is charged to other comprehensive income to the extent of the amount relating to that asset in the revaluation surplus and thereafter in profit or loss.

PPE	Depreciated historical cost $m	Revalued carrying amount $m
31 May 2011	9·00	9·00
Revaluation		2·00
Total	9·00	11·00
Depreciation to 31 May 2012	(0·50)	(0·61)
Balance 31 May 2012	8·50	10·39
Impairment loss	(0·70)	(2·59)
31 May 2012 after impairment loss	7·80	7·80

There will have been a transfer of $0·11 (0·61 – 0·50) million from the revaluation surplus to retained earnings for the excess depreciation charged in the year so the remaining amount in the revaluation surplus is $1·89m (2·00 – 0·11). $1·89m of the impairment will be recognised in other comprehensive income and the remaining $0·7m in profit or loss.

Working 7

Joint operation

SOFP	1 June 2011 $m	Dismantling cost $m	Depreciation $m	Unwinding of discount $m	31 May 2012 $m
PPE	6	2 x 40%	(6·8 x 1/10)		6·12
Trade receivables					8
Trade payables (0·2 + 6·4)					6·6
Provision		0·8		0·04	0·84
Income statement					
Revenue (20·00 x 40%)					8
Cost of sales (16·00 x 40%)					(6·4)
Operating cost (0·50 x 40%)					(0·2)
Depreciation					(0·68)
Finance expense					(0·04)
Net profit					0·68

Working 8

Property, plant and equipment

	$m	$m
Robby	112·00	
Hail	60·00	
Zinc	26·00	
		198·00
Increase in value of land – Hail (60 – 20 – 16)		24·00
Increase in value of PPE – Zinc (26 – 10 – 15)		1·00
Further increase in value of PPE at acquisition		3·00
Less: increased depreciation (1 + 3)/5 x 6/12		(0·40)
Impairment loss		(2·59)
Joint operation (W7)		6·12
Land – option to repurchase		12·00
		241·13

The sale of land should not be recognised in the financial statements as the risks and rewards of ownership have not been transferred. The land can be repurchased at the sale price plus a premium, which represents effectively an interest payment. It is effectively manipulating the financial statements in order to show a better cash position. The land should be reinstated at its carrying amount before the transaction, so $12 million, a current liability recognised of $16 million and the profit on disposal of $4 million that was recorded reversed.

Working 9

Current assets

	$m	$m
Robby	5·00	
Hail	7·00	
Zinc	12·00	
		24·00
Factoring trade receivables		4·00
Joint operation (W7)		8·00
		36·00

Working 10

Current liabilities

	$m
Robby	47·00
Hail	6·00
Zinc	2·00
Secured borrowings	3·60
Joint operation (W7) (6·40 trade payable + 0·20 operating costs)	6·60
Land sale	16·00
	81·20

Working 11

Non-current liabilities

	$m
Robby	53·00
Hail	20·00
Zinc	21·00
Joint operation (0·80 provision + unwinding of discount 0·04) (W7)	0·84
	94·84

(b) (i) FRS 9 *Associates and Joint Ventures* defines a joint venture as an entity in which the reporting entity holds an interest on a long-term basis and is jointly controlled by the reporting entity and one or more other venturers under a contractual arrangement.

FRS 9 also contains guidance for joint arrangements that are not entities (JANEs). A JANE is a contractual arrangement under which the participants engage in joint activities that do not create an entity because it would not be carrying on a trade or business of its own. A contractual arrangement where all significant matters of operating and financial policy are predetermined does not create an entity because the policies are those of its participants, not of a separate entity.

In this instance, the natural gas station is a JANE under FRS 9 as the gas station does not operate with any degree of independence as construction, revenues and expenditures are being determined by the venturers.

IFRS 11 *Joint Arrangements* focuses on the rights and obligations of the arrangement. A joint arrangement is defined as being an arrangement where two or more parties contractually agree to share control. Joint control exists only when the decisions about activities that significantly affect the returns of an arrangement require the unanimous consent of the parties sharing control. All parties to a joint arrangement should recognise their rights and obligations arising from the arrangement. Joint arrangements are either joint operations or joint ventures.

Under IFRS, a joint arrangement is a joint venture whereby the parties only have rights over the net assets and not the individual components comprising the net assets.

Further, a joint arrangement is a joint operation whereby the parties to the arrangement have direct rights/obligation relating to the assets, liabilities, revenues and costs of the arrangement. Those parties are called joint operators. A joint operator will recognise its interest based on its direct rights and obligations rather than on its participation interest. In this instance the joint arrangement is a joint operation as indicated within the scenario.

Under FRS 9 the consolidated financial statements should include joint ventures using the gross equity method. This is the same as the equity method under IFRS, except that:

- in the consolidated profit and loss account the investor's share of its joint ventures' turnover should be shown, but not as part of group turnover;
- in the consolidated balance sheet the investor's share of the gross assets and liabilities underlying the net equity amount included for joint ventures should be shown in amplification of that net amount.

Under FRS 9, participants in a JANE should account for their own assets, liabilities and cash flows, measured according to the terms of the agreement governing the arrangement

Under IFRS 11 a joint venturer recognises its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*, unless the entity is exempted from applying the equity method. A party that participates in, but does not have joint control of, a joint venture accounts for its interest in the arrangement in accordance with IFRS 9 *Financial Instruments* unless it has significant influence over the joint venture, in which case it accounts for it in accordance with IAS 28.

The IFRS states that a joint operator of a joint operation (and not joint venture entities) recognises:

its assets, including its share of any assets held jointly;
its liabilities, including its share of any liabilities incurred jointly;
its revenue from the sale of its share of the output of the joint operation;
its share of the revenue from the sale of the output by the joint operation; and
its expenses, including its share of any expenses incurred jointly.

In conclusion there are differences in the definitions and accounting between RoI GAAP and IFRS. In the case of Robby, the natural gas station would be treated as a JANE under RoI GAAP and as a joint operation under IFRS and not a joint venture entity under either standard. The accounting treatment would be the same under both sets of standards.

(ii) Manipulation of financial statements often does not involve breaking rules, but the purpose of financial statements is to present a fair representation of the company's or group's position, and if the financial statements are misrepresented on purpose then this could be deemed unethical. The financial statements in this case are being manipulated to hide the fact that the group has liquidity problems. The Robby Group has severe problems with a current ratio of 0·44 ($36m/$81·2m) and a gearing ratio of 0·83 ($53 + 20 + 21 + factored receivables 3·6 + land option 16 = 113·6/equity interest including NCI $136·09m). The sale and repurchase of the land would make little difference to the overall position of the company, but would maybe stave off proceedings by the bank if the overdraft were eliminated. Robby has considerable PPE, which may be undervalued if the sale of the land is indicative of the value of all of the PPE.

Accountants have the responsibility to issue financial statements that do not mislead users as they assume that such professionals are acting in an ethical capacity, thus giving the financial statements credibility. Accountants should seek to promote or preserve the public interest. If the idea of a profession is to have any significance, then it must have the trust of users. Accountants should present financial statements that meet the qualitative characteristics set out in the Framework. Faithful representation and verifiability are two such concepts and it is critical that these concepts are applied in the preparation and disclosure of financial information.

2 (a) A lease is classified as a finance lease if it transfers substantially the entire 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. Situations that would normally lead to a lease being classified as a finance lease include the following:

- 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 which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain 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 lease assets are of a specialised nature such that only the lessee can use them without major modifications being made.

In this case the lease back of the building is for the major part of the building's economic life and the present value of the minimum lease payments amounts to all of the fair value of the leased asset. Therefore the lease should be recorded as a finance lease.

The building is derecognised at its carrying amount and then reinstated at its fair value with any disposal gain, in this instance $1·5 million ($5m – $3·5m) being deferred over the new lease term. The building is depreciated over the shorter of the lease term and useful economic life, so 20 years. Finance lease accounting results in a liability being created, finance charge accruing at the implicit rate within the lease, in this case 7%, and the payment reducing the lease liability in arriving at the year-end balance. The associated double entry for the lease is as follows:

		$000	$000
Sale of building			
Dr	cash	5,000	
Cr	building		3,500
	deferred income		1,500
Leased asset and liability			
Dr	asset – finance lease	5,000	
Cr	finance lease creditor		5,000
Deferred income release			
Dr	deferred income	75	
Cr	profit or loss		75
Depreciation of asset			
Dr	depreciation	250	
Cr	assets under finance lease		250
Rentals paid			
Dr	interest	350	
	finance lease creditor	91	
Cr	cash		441

(b) Under IAS 19 *Employee Benefits*, the accounting procedures would be:

Recognition of actuarial gains and losses (remeasurements):

Actuarial gains and losses are renamed 'remeasurements' and will be recognised immediately in 'other comprehensive income' (OCI). Actuarial gains and losses cannot be deferred or recognised in profit or loss; this is likely to increase volatility in the statement of financial position and OCI. Remeasurements recognised in OCI cannot be recycled through profit or loss in subsequent periods. Thus William will not be able to spread these gains and losses over the remaining working life of the employees.

Recognition of past service cost:

Past-service costs are recognised in the period of a plan amendment; unvested benefits cannot be spread over a future-service period. The plan benefits which were enhanced on 1 June 2011 would have to be immediately recognised and the unvested benefits would not be spread over five years from that date. A curtailment occurs only when an entity reduces significantly the number of employees. Curtailment gains/losses are accounted for as past-service costs. Thus William will need to realise that any curtailment is only recognised in these circumstances and will result in immediate recognition of any gain or loss.

Measurement of pension expense:

Annual expense for a funded benefit plan will include net interest expense or income, calculated by applying the discount rate to the net defined benefit asset or liability. The discount rate used is a high-quality corporate bond rate where there is a deep market in such bonds, and a government bond rate in other markets.

Presentation in the income statement:

The benefit cost will be split between (i) the cost of benefits accrued in the current period (service cost) and benefit changes (past-service cost, settlements and curtailments); and (ii) finance expense or income. This analysis can be in the income statement or in the notes.

(c) Expenses in respect of cash-settled share-based payment transactions should be recognised over the period during which goods are received or services are rendered, and measured at the fair value of the liability. The fair value of the liability should be remeasured at each reporting date until settled. Changes in fair value are recognised in the statement of comprehensive income.

The credit entry in respect of a cash-settled share-based payment transaction is presented as a liability. The fair value of each share appreciation right (SAR) is made up of an intrinsic value and its time value. The time value reflects the fact that the holders of each SAR have the right to participate in future gains. At 31 May 2012, the expense will comprise any increase in the liability plus the cash paid based on the intrinsic value of the SAR.

Liability 31 May 2012 (10 x 500 x $24)	$120,000
Liability 31 May 2011 (17 x 500 x $14)	($119,000)
Cash paid (7 x 500 x $21)	$73,500
Expense year ending 31 May 2012	$74,500

Therefore the expense for the year is $74,500 and the liability at the year end is $120,000.

(d) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* describes contingent liabilities in two ways. Firstly, as reliably possible obligations whose existence will be confirmed only on the occurrence or non-occurrence of uncertain future events outside the entity's control, or secondly, as present obligations that are not recognised because: (a) it is not probable that an outflow of economic benefits will be required to settle the obligation; or (b) the amount cannot be measured reliably.

In Chrissy's financial statements contingent liabilities are not recognised but are disclosed and described in the notes to the financial statements, including an estimate of their potential financial effect and uncertainties relating to the amount or timing of any outflow, unless the possibility of settlement is remote.

However, in a business combination, a contingent liability is recognised if it meets the definition of a liability and if it can be measured. The first type of contingent liability above under IAS 37 is not recognised in a business combination. However, the second type of contingency is recognised whether or not it is probable that an outflow of economic benefits takes place but only if it can be measured reliably. This means William would recognise a liability of $4 million in the consolidated accounts. Contingent liabilities are an exception to the recognition principle because of the reliable measurement criteria.

3 (a) (i) The fair value model in IAS 40 *Investment Property* defines fair value as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. Fair value should reflect market conditions at the date of the statement of financial position. The standard gives a considerable amount of guidance on determining fair value; in particular, that the best evidence of fair value is given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other constraints. Therefore investment properties are not being valued in accordance with the best possible method. This means that goodwill recognised on the acquisition of an investment property through a business combination of real estate investment companies is different as compared to what it should be under IFRS 3 *Business Combination* valuation principles. In reality, the fair value of both the property and the deferred tax liability are reflected in the purchase price of the business combination. The difference between this purchase price and the net assets recognised according to IFRS 3, upon which deferred tax is based, is recognised as goodwill in the consolidated statement of financial position.

Ethan's methods for determining whether goodwill is impaired, and the amount it is impaired by, is not in accordance with IAS 36 *Impairment of Assets*. The standard requires assets (or cash generating units (CGU) if not possible to conduct the review on an asset by asset basis) to be stated at the lower of carrying amount and recoverable amount. The recoverable amount is the higher of fair value less costs to sell and value in use. Fair value less costs to sell is a post-tax valuation taking account of deferred taxes. According to IAS 36, the deferred tax liability should be included in calculating the carrying amount of the CGU, since the transaction price also includes the effect of the deferred tax and the purchaser assumes the tax risk. Therefore, the impairment testing of goodwill should be based on recoverable amount, rather than on the relationship between the goodwill and the deferred tax liability as assessed by Ethan.

Ethan should disclose both the methodology by which the recoverable amount of the CGU, and therefore goodwill, is determined and the assumptions underlying that methodology under the requirements of IAS 36. The standard requires Ethan to state the basis on which recoverable amount has been determined and to disclose the key assumptions on which it is based.

In accordance with IAS 36, where impairment testing takes place, goodwill is allocated to each individual real estate investment identified as a cash-generating unit (CGU). Periodically, but at least annually, the recoverable amount of the CGU is compared with its carrying amount. If this comparison results in the carrying amount being greater than the recoverable amount, the impairment is first allocated to the goodwill. Any further difference is subsequently allocated against the value of the investment property.

(ii) Normally debt issued to finance Ethan's investment properties would be accounted for using amortised cost model. However, Ethan may apply the fair value option in IFRS 9 *Financial Instruments* as such application would eliminate or significantly reduce a measurement or recognition inconsistency between the debt liabilities and the investment properties to which they are related. The provision requires there to be a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. The option is not restricted to financial assets and financial liabilities. The IASB concludes that accounting mismatches may occur in a wide variety of circumstances and that financial reporting is best served by providing entities with the opportunity of eliminating such mismatches where that results in more relevant information. Ethan supported the application of the fair value option with the argument that there is a specific financial correlation between the factors that form the basis of the measurement of the fair value of the investment properties and the related debt. Particular importance was placed on the role played by interest rates, although it is acknowledged that the value of investment properties will also depend, to some extent, on rent, location and maintenance and other factors. For some investment properties, however, the value of the properties will be dependent on the movement in interest rates.

Under IFRS 9, entities with financial liabilities designated as FVTPL recognise changes in the fair value due to changes in the liability's credit risk directly in other comprehensive income (OCI). There is no subsequent recycling of the amounts in OCI to profit or loss, but accumulated gains or losses may be transferred within equity. The movement in fair value due to other factors would be recognised within profit or loss. However, if presenting the change in fair value attributable to the credit risk of the liability in OCI would create or enlarge an accounting mismatch in profit or loss, all fair value movements are recognised in profit or loss. An entity is required to determine whether an accounting mismatch is created when the financial liability is first recognised, and this determination is not reassessed. The mismatch must arise due to an economic relationship between the financial liability and the associated asset that results in the liability's credit risk being offset by a change in the fair value of the asset. Financial liabilities that are required to be measured at FVTPL (as distinct from those that the entity has designated at FVTPL), including financial guarantees and loan commitments measured at FVTPL, have all fair value movement recognised in profit or loss. IFRS 9 retains the flexibility that existed in IFRS 7 *Financial Instruments: Disclosures* to determine the amount of fair value change that relates to changes in the credit risk of the liability.

(iii) Ethan's classification of the B shares as equity instruments does not comply with IAS 32 *Financial Instruments: Presentation*. IAS 32 paragraph 11 defines a financial liability to include, amongst others, any liability that includes a contractual obligation to deliver cash or financial assets to another entity. The criteria for classification of a financial instrument as equity rather than liability are provided in IAS 32 paragraph 16. This states that the instrument is an equity instrument rather than a financial liability if, and only if, the instrument does not include a contractual obligation either to deliver cash or another financial asset to the entity or to exchange financial assets or liabilities with another entity under conditions that are potentially unfavourable to Ethan. IAS 32 paragraph AG29 explains that when classifying a financial instrument in consolidated financial statements, an entity should consider all the terms and conditions agreed between members of a group and holders of the instrument, in determining whether the group as a whole has an obligation to deliver cash or another financial instrument in respect of the instrument or to settle it in a manner that results in classification as a liability. Therefore, since the operating subsidiary is obliged to pay an annual cumulative dividend on the B shares and does not have discretion over the distribution of such dividend, the shares held by Ethan's external shareholders should be classified as a financial liability in Ethan's consolidated financial statements and not non-controlling interest. The shares being held by Ethan will be eliminated on consolidation as intercompany.

(b) In respect of deferred tax, IAS 12 *Income Taxes* is conceptually different from FRS 19 *Deferred Tax*. There are significant differences between the two standards. RoI standard setters do not agree with the conceptual arguments underpinning the requirements of IAS 12, which it believes lead to companies making excessive provisions. They have therefore taken a different conceptual approach. The most important practical consequence is that, unlike IAS 12, the FRS does not in general require deferred tax to be provided for when non-monetary assets are revalued or when they are adjusted to their fair values on the acquisition of a business.

FRS 19 *Deferred Tax* requires full provision to be made for deferred tax assets and liabilities arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in a tax computation. The general principle underlying the requirements is that deferred tax should be recognised as a liability or asset if the transactions or events that give the entity an obligation to pay more tax in future or a right to pay less tax in future have occurred by the balance sheet date. FRS 19 requires recognition of a provision for deferred tax using an incremental liability approach on the basis of timing differences that have been originated but not reversed at the balance sheet date. Timing differences originate in one period and can be reversed in one or subsequent periods.

Instead of accounting for timing differences which is the basis used in FRS 19, IAS 12 uses a balance sheet concept of temporary differences which are differences between the carrying amount of assets, liabilities, income and expenditure and their tax base. Temporary differences include not only timing differences, but other differences between the accounting and tax bases of assets, liabilities, income and expenditure that are not timing differences, for example, revaluation of assets for which no equivalent adjustment is made for tax purposes. Under IAS 12, deferred tax is always recognised on revaluation gains. Under FRS 19, deferred tax on revaluation gains is only recognised if there is a binding agreement to sell the revalued asset and the gain expected to arise on sale has been recognised or where an asset is continuously revalued to fair value with changes in fair value being recognised in the profit and loss account. It would not apply to a single and one off revaluation of an asset which is above historical cost but which is caused by a clear consumption of economic benefits.

Another significant difference is that FRS 19 allows, but does not require, deferred tax liabilities that will not be settled for some time to be discounted to reflect the time value of money. In contrast, IAS 12 prohibits discounting.

SSAP 19 *Investment Property* requires investment properties to be carried at open market value and does not permit such property to be carried at depreciated historical cost. If the value of investment properties changes, it should not be taken to the profit and loss account but should be taken to the investment revaluation reserve unless a deficit on an individual property is expected to be permanent. Thus although investment property is continuously revalued, the changes in value do not go to the profit and loss account, and no deferred taxation would be provided under RoI GAAP on investment property.

4 (a) (i) The existing guidance requires a provision to be recognised when: (a) it is probable that an obligation exists; (b) it is probable that an outflow of resources will be required to settle that obligation; and (c) the obligation can be measured reliably. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date, that is, the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party. This guidance, when applied consistently, provides useful, predictive information about non-financial liabilities and the expected future cash flows, and is consistent with the recognition criteria in the Framework. The IASB has initiated a project to replace IAS 37 for three main reasons:

1. To address inconsistencies with other IFRSs. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires an entity to record an obligation as a liability only if it is probable (i.e. more than 50% likely) that the obligation will result in an outflow of cash or other resources from the entity. Other standards, such as IFRS 3 *Business Combinations* and IFRS 9 *Financial Instruments*, do not apply this 'probability of outflows' criterion to liabilities.
2. To achieve global convergence of accounting standards. The IASB is seeking to eliminate differences between IFRSs and US generally accepted accounting principles (US GAAP). At present, IFRSs and US GAAP differ in how they treat the costs of restructuring a business. IAS 37 requires an entity to record a liability for the total costs of restructuring a business when it announces or starts to implement a restructuring plan. In contrast, US GAAP requires an entity to record a liability for individual costs of a restructuring only when the entity has incurred that particular cost.

3. To improve measurement of liabilities in IAS 37. The requirements in IAS 37 for measuring liabilities are unclear. As a result, entities use different measures, making it difficult for analysts and investors to compare their financial statements. Two aspects of IAS 37 are particularly unclear. IAS 37 requires entities to measure liabilities at the 'best estimate' of the expenditure required to settle the obligation. In practice, there are different interpretations of what 'best estimate' means: the most likely outcome, the weighted average of all possible outcomes or even the minimum or maximum amount in the range of possible outcomes. IAS 37 does not specify the costs that entities should include in the measurement of a liability. In practice, entities include different costs. Some entities include only incremental costs while others include all direct costs, plus indirect costs and overheads, or use the prices they would pay contractors to fulfil the obligation on their behalf.

(ii) The IASB has decided that the new IFRS will not include the 'probability of outflows' criterion. Instead, an entity should account for uncertainty about the amount and timing of outflows by using a measurement that reflects their expected value, i.e. the probability-weighted average of the outflows for the range of possible outcomes. Removal of this criterion focuses attention on the definition of a liability in the Framework, which is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Furthermore, the new IFRS will require an entity to record a liability for each individual cost of a restructuring only when the entity incurs that particular cost.

The exposure draft proposes that the measurement should be the amount that the entity would rationally pay at the measurement date to be relieved of the liability. Normally, this amount would be an estimate of the present value of the resources required to fulfil the liability. It could also be the amount that the entity would pay to cancel or fulfil the obligation, whichever is the lowest. The estimate would take into account the expected outflows of resources, the time value of money and the risk that the actual outflows might ultimately differ from the expected outflows.

If the liability is to pay cash to a counterparty (for example to settle a legal dispute), the outflows would be the expected cash payments plus any associated costs, such as legal fees. If the liability is to undertake a service, for example to decommission plant at a future date, the outflows would be the amounts that the entity estimates it would pay a contractor at the future date to undertake the service on its behalf. Obligations involving services are to be measured by reference to the price that a contractor would charge to undertake the service, irrespective of whether the entity is carrying out the work internally or externally.

(b) Under IAS 37, a provision of $105 million would be recognised since this is the estimate of the present obligation. There will be no profit or loss impact other than the adjustment of the present value of the obligation to reflect the time value of money by unwinding the discount.

Under the proposed approach there are a number of different outcomes:

– with no risk and probability adjustment, the initial liability would be recognised at $129 million which is the present value of the resources required to fulfil the obligation based upon third-party prices. This means that in 10 years the provision would have unwound to $180 million, the entity will spend $150 million in decommission costs and a profit of $30 million would be recognised. If there were no market for the dismantling of the platform, then Royan would recognise a liability by estimating the price that it would charge another party to carry out the service.

– With risk and probability being taken into account, then the expected value would be (40% x $129m + 60% x $140m), i.e. $135·6m plus the risk adjustment of $5 million, which totals $140·6 million.

– $105 million being the present value of the future cashflows discounted.

The ED suggests within paragraph 36B that the entity should take the lower of:

(a) the present value of the resources required to fulfil the obligation, i.e. $105 million;

(b) the amount that the entity would have to pay to cancel the obligation, for which information is not available here; and

(c) the amount that the entity would have to pay to transfer the obligation to a third party, i.e. $129 million without risk or $140·6 million incorporating risk.

Therefore $105 million should be provided.

The ED makes specific reference to provisions relating to services such as decommissioning where it suggests that the amount to transfer to a third party would be the required liability, so $140·6 million would be provided.

			Marks
1	**(a)**	Property, plant and equipment	6
		Goodwill	6
		NCI	4
		Financial asset	1
		Current asset	3
		OCE	3
		Retained earnings	6
		Non-current liabilities	2
		Current liabilities	4
			35
	(b)	**(i)** 1 mark per point up to max	9
		(ii) Manipulation	2
		Ethical discussion	4
			6
			50
2	**(a)**	Definition of lease	3
		Leaseback principle	1
		Accounting	3
	(b)	Accounting treatment	7
	(c)	Cash-based payments	2
		Calculation	3
	(d)	Contingent liability – discussion	4
		Communication skills	2
			25
3		Impairment testing	5
		Fair value option – IFRS 9	7
		Financial liability	5
		Deferred taxation	6
		Communication skills	2
			25
4		Existing guidance and critique	9
		New proposals	7
		IAS 37 and ED	7
		Communication skills	2
			25