

Professional Pilot Paper – Essentials module

Corporate Reporting (International)

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

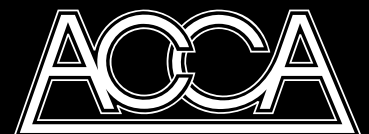
Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants



Paper P2 (INT)

Section A – This ONE question is compulsory and MUST be attempted

1 The following draft financial statements relate to Zambeze, a public limited company:

Draft Group Balance Sheets at 30 June

	2006 \$m	2005 \$m
Assets:		
Non-current assets:		
Property, plant and equipment	1,315	1,005
Goodwill	30	25
Investment in associate	270	290
	<u>1,615</u>	<u>1,320</u>
Current assets:		
Inventories	650	580
Trade receivables	610	530
Cash at bank and cash equivalents	50	140
	<u>1,310</u>	<u>1,250</u>
Total assets	<u>2,925</u>	<u>2,570</u>
Equity and liabilities:		
Share capital	100	85
Share premium account	30	15
Revaluation reserve	50	145
Retained earnings	254	250
	<u>434</u>	<u>495</u>
Minority interest	60	45
Total equity	<u>494</u>	<u>540</u>
Non-current liabilities	850	600
Current liabilities	1,581	1,430
Total liabilities	<u>2,431</u>	<u>2,030</u>
Total equity and liabilities	<u>2,925</u>	<u>2,570</u>

Draft Group Income Statement for the year ended 30 June 2006

	\$m
Revenue	4,700
Cost of sales	(3,400)
Gross profit	<u>1,300</u>
Distribution and administrative expenses	(600)
Finance costs (interest payable)	(40)
Share of profit in associate	30
Profit before tax	<u>690</u>
Income tax expense (including tax on income from associate \$10 million)	(210)
Profit for the period	<u>480</u>
Attributable to:	
Equity holders of the parent	455
Minority interest	25
	<u>480</u>

Draft Group Statement of Recognised Income and Expense for the year ended 30 June 2006

	\$m
Foreign exchange difference of associate	(5)
Impairment losses on property, plant and equipment offset against revaluation surplus	(95)
Net expense recognised in equity	(100)
Profit for period	455
Total recognised income and expense	<u>355</u>

Draft Statement of changes in equity for the year ended 30 June 2006

	\$m
Total recognised income and expense for the period	355
Dividends paid	(446)
New shares issued	30
Total movement during the year	(61)
Shareholders' funds at 1 July 2005	495
Shareholders' funds at 30 June 2006	<u>434</u>

The following relates to Zambeze:

- (i) Zambeze acquired a seventy per cent holding in Damp, a public limited company, on 1 July 2005. The fair values of the net assets acquired were as follows:

	\$m
Property, plant and equipment	70
Inventories and work in progress	90
	<u>160</u>

The purchase consideration was \$100 million in cash and \$25 million (discounted value) deferred consideration which is payable on 1 July 2006. The difference between the discounted value of the deferred consideration (\$25 million) and the amount payable (\$29 million) is included in "interest payable". Zambeze wants to set up a provision for reconstruction costs of \$10 million retrospectively on the acquisition of Damp. This provision has not yet been set up.

- (ii) There had been no disposals of property, plant and equipment during the year. Depreciation for the period charged in cost of sales was \$60 million.
- (iii) Current liabilities comprised the following items:

	2006	2005
	\$m	\$m
Trade payables	1,341	1,200
Interest payable	50	45
Taxation	190	185
	<u>1,581</u>	<u>1,430</u>

- (iv) Non-current liabilities comprised the following:

	2006	2005
	\$m	\$m
Deferred consideration – purchase of Damp	29	–
Liability for the purchase of Property, plant and equipment	144	–
Loans repayable	621	555
Provision for deferred tax	30	25
Retirement benefit liability	26	20
	<u>850</u>	<u>600</u>

(v) The retirement benefit liability comprised the following:

	\$m
Movement in year:	
Liability at 1 July 2005	20
Current and past service costs charged to income statement	13
Contributions paid to retirement benefit scheme	(7)
	26
Liability 30 June 2006	26

There was no actuarial gain or loss in the year.

(vi) Goodwill was impairment tested on 30 June 2006 and any impairment was included in the financial statements for the year ended 30 June 2006.

(vii) The Finance Director has set up a company, River, through which Zambeze conducts its investment activities. Zambeze has paid \$400 million to River during the year and this has been included in dividends paid. The money was invested in a specified portfolio of investments. Ninety five per cent of the profits and one hundred per cent of the losses in the specified portfolio of investments are transferred to Zambeze. An investment manager has charge of the company's investments and owns all of the share capital of River. An agreement between the investment manager and Zambeze sets out the operating guidelines and prohibits the investment manager from obtaining access to the investments for the manager's benefit. An annual transfer of the profit/loss will occur on 30 June annually and the capital will be returned in four years time. The transfer of \$400 million cash occurred on 1 January 2006 but no transfer of profit/loss has yet occurred. The balance sheet of River at 30 June 2006 is as follows:

River – Balance sheet at 30 June 2006

	\$m
Investment at fair value through profit or loss	390
	390
Share capital	400
Retained earnings	(10)
	390

Required:

(a) **Prepare a group cash flow statement for the Zambeze Group for the year ended 30 June 2006 using the indirect method.** (35 marks)

(b) **Discuss the issues which would determine whether River should be consolidated by Zambeze in the group financial statements.** (9 marks)

(c) **Discuss briefly the importance of ethical behaviour in the preparation of financial statements and whether the creation of River could constitute unethical practice by the finance director of Zambeze.** (6 marks)

Two marks are available for the quality of the discussion of the issues regarding the consolidation of River and the importance of ethical behaviour.

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Electron, a public limited company, operates in the energy sector. The company has grown significantly over the last few years and is currently preparing its financial statements for the year ended 30 June 2006.

Electron buys and sells oil and currently has a number of oil trading contracts. The contracts to purchase oil are treated as non-current assets and amortised over the contracts' durations. On acceptance of a contract to sell oil, fifty per cent of the contract price is recognised immediately with the balance being recognised over the remaining life of the contract. The contracts always result in the delivery of the commodity. (4 marks)

Electron has recently constructed an ecologically efficient power station. A condition of being granted the operating licence by the government is that the power station be dismantled at the end of its life which is estimated to be 20 years. The power station cost \$100 million and began production on 1 July 2005. Depreciation is charged on the power station using the straight line method. Electron has estimated at 30 June 2006, it will cost \$15 million (net present value) to restore the site to its original condition using a discount rate of five per cent. Ninety-five per cent of these costs relate to the removal of the power station and five per cent relates to the damage caused through generating energy. (7 marks)

Electron has leased another power station which was relatively inefficient, to a rival company on 30 June 2006. The beneficial and legal ownership remains with Electron and in the event of one of Electron's power stations being unable to produce energy, Electron can terminate the agreement. The leased power station is being treated as an operating lease with the net present value of the income of \$40 million being recognised in profit or loss. The fair value of the power station is \$70 million at 30 June 2006. A deposit of \$10 million was received on 30 June 2006 and it is included in the net present value calculation. (5 marks)

The company has a good relationship with its shareholders and employees. It has adopted a strategy of gradually increasing its dividend payments over the years. On 1 August 2006, the board proposed a dividend of 5c per share for the year ended 30 June 2006. The shareholders will approve the dividend along with the financial statements at the general meeting on 1 September 2006 and the dividend will be paid on 14 September 2006. The directors feel that the dividend should be accrued in the financial statements for the year ended 30 June 2006 as a "valid expectation" has been created. (3 marks)

The company granted share options to its employees on 1 July 2005. The fair value of the options at that date was \$3 million. The options vest on 30 June 2008. The employees have to be employed at the end of the three year period for the options to vest and the following estimates have been made:

Estimated percentage of employees leaving during vesting period at:

Grant date 1 July 2005	5%	
30 June 2006	6%	(4 marks)
Effective communication to the directors		(2 marks)

Required:

Draft a report suitable for presentation to the directors of Electron which discusses the accounting treatment of the above transactions in the financial statements for the year ended 30 June 2006, including relevant calculations.

(25 marks)

3 The following balance sheet relates to Kesare Group, a public limited company at 30 June 2006:

	\$'000
Assets:	
Non current assets:	
Property, plant, and equipment	10,000
Goodwill	6,000
Other intangible assets	5,000
Financial assets (cost)	9,000
	30,000
Trade receivables	7,000
Other receivables	4,600
Cash and cash equivalents	6,700
	18,300
Total assets	48,300
Equity and liabilities	
Share capital	9,000
Other reserves	4,500
Retained earnings	9,130
Total equity	22,630
Non-current liabilities	
Long term borrowings	10,000
Deferred tax liability	3,600
Employee benefit liability	4,000
Total non-current liabilities	17,600
Current liabilities	
Current tax liability	3,070
Trade and other payables	5,000
Total current liabilities	8,070
Total liabilities	25,670
Total equity and liabilities	48,300

The following information is relevant to the above balance sheet:

- (i) The financial assets are classified as “available for sale” but are shown in the above balance sheet at their cost on 1 July 2005. The market value of the assets is \$10.5 million on 30 June 2006. Taxation is payable on the sale of the assets.
- (ii) The stated interest rate for the long term borrowing is 8 per cent. The loan of \$10 million represents a convertible bond which has a liability component of \$9.6 million and an equity component of \$0.4 million. The bond was issued on 30 June 2006.
- (iii) The defined benefit plan had a rule change on 1 July 2005. Kesare estimate that of the past service costs of \$1 million, 40 per cent relates to vested benefits and 60 per cent relates to benefits that will vest over the next five years from that date. The past service costs have not been accounted for.
- (iv) The tax bases of the assets and liabilities are the same as their carrying amounts in the balance sheet at 30 June 2006 except for the following:

(a)	\$'000
Property, plant, and equipment	2,400
Trade receivables	7,500
Other receivables	5,000
Employee benefits	5,000

- (b) Other intangible assets were development costs which were all allowed for tax purposes when the cost was incurred in 2005.
- (c) Trade and other payables includes an accrual for compensation to be paid to employees. This amounts to \$1 million and is allowed for taxation when paid.
- (v) Goodwill is not allowable for tax purposes in this jurisdiction.
- (vi) Assume taxation is payable at 30%.

Required:

- (a) **Discuss the conceptual basis for the recognition of deferred taxation using the temporary difference approach to deferred taxation.** (7 marks)
- (b) **Calculate the provision for deferred tax at 30 June 2006 after any necessary adjustments to the financial statements showing how the provision for deferred taxation would be dealt with in the financial statements. (Assume that any adjustments do not affect current tax. Candidates should briefly discuss the adjustments required to calculate the provision for deferred tax).** (18 marks)

Two marks will be awarded for the quality of the discussion of the conceptual basis of deferred taxation in (a).

(25 marks)

- 4 A significant number of entities and countries around the world have adopted International Financial Reporting Standards (IFRS) as their basis for financial reporting, often regarding these as a means to improve the quality of information on corporate performance. However, while the advantages of a common set of global reporting standards are recognised, there are a number of implementation challenges at the international and national levels if the objective of an improved and harmonised reporting system is to be achieved.

Required:

- (a) **Discuss the implementation challenges faced by the International Accounting Standards Board (IASB) if there is to be a successful move to International Financial Reporting Standards.** (18 marks)
- (b) The International Accounting Standards Board recently issued Exposure Drafts of *Proposed Amendments to IFRS3 Business Combinations* and *IAS27 Consolidated and Separate Financial Statements*. The proposals radically change the basis of reporting business combinations and transactions with minority interests.
Discuss how the above exposure drafts will fundamentally affect the existing accounting practices for business combinations. (7 marks)

Two marks will be awarded for the quality of the discussion of the ideas and information.

(25 marks)

End of Question Paper

Answers

1 (a) Zambeze Group
Group Statement of Cash Flows for the year ended 30 June 2006

	\$m	\$m
Cash flows from operating activities:		
Net profit before taxation		690
Adjustments for:		
Share of profit in associate	(30)	
Depreciation	60	
Impairment of goodwill (Working 2)	8	
Interest expense	40	
Retirement benefit expense	13	
	<u> </u>	91
Operating profit before working capital changes:		<u>781</u>
Increase in trade receivables	(80)	
Decrease in inventories (650-580-90)	20	
Increase in trade payables	141	
	<u> </u>	81
Cash generated from operations:		<u>862</u>
Interest paid (Working 5)	(31)	
Income taxes paid (Working 4)	(190)	
Cash paid to retirement benefit scheme	(7)	
	<u> </u>	(228)
Net cash from operating activities:		<u>634</u>
Cash flows from investing activities		
Acquisition of subsidiary	(100)	
Purchase of property, plant and equipment (Working 1)	(251)	
Dividends received from Associate (Working 3)	35	
Investment in River	(400)	
	<u> </u>	(716)
Net cash used in investing activities		(716)
Cash flows from financing activities:		
Proceeds from issue of share capital	30	
Increase in long-term borrowings	66	
Dividends paid (Working 6)	(46)	
Minority interest dividends (Working 2)	(58)	
	<u> </u>	(8)
Net cash used in financing activities		(8)
Net decrease in cash and cash equivalents		<u>(90)</u>
Cash and cash equivalents at beginning of period		<u>140</u>
Cash and cash equivalents at the end of period		<u><u>50</u></u>

Working 1

	\$m
Tangible non-current assets	
Balance at 1 July 2005	1,005
Impairment losses	(95)
Depreciation	(60)
Purchases (by deduction)	395
Acquisition – Damp	70
	<u> </u>
Closing balance	<u>1,315</u>

Cash flow is \$395 million minus the liability for Property, plant and equipment of \$144 million, ie \$251 million.

<i>Working 2</i>		\$m
Purchase of subsidiary:		
Net assets acquired		160
Group's share of net assets (70%)		112
Goodwill		13
Purchase consideration (100+25)		125
Goodwill:		
Balance at 1 July 2005		25
Goodwill on subsidiary		13
Impairment		(8)
Balance at 30 June 2006		30
Minority interest:		
Balance at 1 July 2005		45
Acquisition of Damp (160 x 30%)		48
Profit for year		25
Dividend		(58)
Balance at 30 June 2006		60

<i>Working 3</i>		\$m
Dividend from associate:		
Balance at 1 July 2005		290
Income (net of tax) (30-10)		20
Foreign exchange loss		(5)
Dividends received (difference)		(35)
Balance at 30 June 2006		270

<i>Working 4</i>		\$m	\$m
Taxation:			
Balance at 1 July 2005	Income tax		185
	Deferred tax		25
Income statements (210-10)			200
Tax paid (difference)			(190)
Balance at 30 June 2006	Income tax	190	
	Deferred tax	30	
		<u> </u>	<u>220</u>

<i>Working 5</i>		\$m
Interest paid:		
Balance at 1 July 2005		45
Income statement		40
Unwinding of discount on purchase		(4)
Cash paid (difference)		(31)
Closing balance at 30 June 2006		50

Working 6

The cash payment to River should be shown as "investing activities" of \$400 million and the dividend paid will then be \$(446-400) million, ie \$46 million.

- (b) The definition of "control" underpins the definition of the parent and subsidiary relationship. IAS27 *Consolidated and separate financial statements* states that control is presumed when the parent acquires more than half of the voting rights of the enterprise. Even when more than one half of the voting rights is not acquired, control may be evidenced by power (IAS27, para 13)
- (i) over more than one half of the voting rights by virtue of an agreement with other investors; or
 - (ii) to govern the financial and operating policies of the other enterprise under a statute or an agreement; or
 - (iii) to appoint or remove the majority of the members of the board of directors; or
 - (iv) to cast the majority of votes at a meeting of the board of directors.

IAS27 emphasises that the reference to power in the definition of “control” means the ability to do or affect something. As a result an entity has control over another entity when it has the ability to exercise that power, regardless of whether control is actively demonstrated or passive in nature. Further SIC12, *Consolidation – Special Purpose Entities* says that special purpose entities (SPEs) should be consolidated where the substance of the relationship indicates that the SPE is controlled by the reporting enterprise. This may arise even where the activities of the SPE are predetermined or whether the majority of voting or equity are not held by the reporting enterprise.

Under IAS27 control of an entity comprises the ability to control the entity’s decision making with a view to obtaining benefits from the entity. The ability to control decision making alone is not sufficient to establish control for accounting purposes but must be accompanied by the objective of obtaining benefits from the entity’s activities. If a company obtains the benefits of ownership, is exposed to the risks of ownership, and can exercise decision making powers to obtain those benefits, then the company must control the third party.

Zambeze should consolidate River as Zambeze controls it through the operating guidelines. Zambeze also receives 95% of the profits and suffers all the losses of River. The guidelines were set up when River was formed and, therefore, the company was set up as a vehicle with the objective of keeping certain transactions off the balance sheet of Zambeze. The investment manager manages the investments of River within the guidelines and incurs no risk and receives 5% of the profits for the management services.

- (c) Ethics in accounting is of utmost importance to accounting professionals and those who rely on their services. Accounting professionals know that people who use their services, especially decision makers using financial statements, expect them to be highly competent, reliable, and objective. Those who work in the field of accounting must not only be well qualified but must also possess a high degree of professional integrity. A professional’s good reputation is one of his or her most important assets.

There is a very fine line between acceptable accounting practice and management’s deliberate misrepresentation in the financial statements. The financial statements must meet the following criteria:

- (i) Technical compliance: A transaction must be recorded in accordance with generally accepted accounting principles (GAAP).
- (ii) Economic substance: The resulting financial statements must represent the economic substance of the event that has occurred.
- (iii) Full disclosure and transparency: Sufficient disclosure must be made so that the effects of transactions are transparent to the reader of the financial statements.

In the case of River it could be argued that the first criterion may be met because the transaction is apparently recorded in technical compliance with IFRS, but technical compliance alone is not sufficient. The second criterion is not met because the transaction as recorded does not reflect the economic substance of the event that has occurred.

Accounting plays a critical function in society. Accounting numbers affect human behaviour especially when it affects compensation, and to deliberately mask the nature of accounting transactions could be deemed to be unethical behaviour.

River was set up with the express purpose of keeping its activities off the balance sheet. The Finance Director has an ethical responsibility to the shareholders of Zambeze and society not to mask the true nature of the transactions with this entity. Further, if the transaction has been authorised by the Finance Director without the authority or knowledge of the Board of Directors, then a further ethical issue arises. Showing the transfer of funds as a dividend paid is unethical and possibly illegal in the jurisdiction. The transfer should not be hidden and River should be consolidated.

2 Report to directors of Electron

Terms of reference

This report sets out the nature of the accounting treatment and concerns regarding the following matters:

- Oil contracts
- Power station
- Operating leases
- Proposed dividend
- Share options.

Oil Contracts

The accounting policy adopted for the agreements relating to the oil contracts raises a number of concerns. The revenue recognition policy currently used is inflating revenue in the first year of the contract with 50% of the revenue being recognised, but a smaller proportion of the costs are recognised in the form of depreciation. Over the life of the contract, costs and revenues are equally matched but in the short term there is a bias towards a more immediate recognition of revenue against a straight line cost deferral policy. Additionally oil sales result in revenue whilst purchases of oil result in a tangible non-current asset. IAS18 *Revenue* states that revenue and expenses that relate to the same transaction or event should be recognised simultaneously and the “Framework” says that the “measurement and display of the financial effect of like transactions must be carried out in a consistent way”. Accounting policies should provide a framework to ensure that this occurs. The current accounting practice seems to be out of line with IAS18 and the *Framework*.

However, the election of the company to use some form of deferral policy for its agreements is to be commended as it attempts to bring its revenue recognition policy in line with the length of the agreements. The main problem is the lack of a detailed accounting

standard on revenue recognition. The result is the current lack of consistency in accounting for long-term agreements. However, it may be advisable to adopt a deferral policy in terms of this type of revenue. The contracts always result in the delivery of the oil in the normal course of business and are not, therefore, accounted for as financial instruments as they qualify as normal sale and purchase contracts.

Power Station

Under IAS37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be made at the balance sheet date for the discounted cost of the removal of the power station because of the following reasons:

- (i) the installation of the power station creates an obligating event
- (ii) the operating licence creates a legal obligation which is likely to occur
- (iii) the costs of removal will have to be incurred irrespective of the future operations of the company and cannot be avoided
- (iv) a transfer of economic benefits (ie the costs of removal) will be required to settle the obligation
- (v) a reasonable estimate of the obligation can be made although it is difficult to estimate a cost which will be incurred in twenty years time (IAS 37 says that only in exceptional circumstances will it not be possible to make some estimate of the obligation)

The costs to be incurred will be treated as part of the cost of the facility to be depreciated over its production life. However, the costs relating to the damage caused by the generation of energy should not be included in the provision, until the power is generated which in this case would be 5% of the total discounted provision. The accounting for the provision is shown in Appendix 1.

Operating Leases

SIC27 *Evaluating the substance of transactions involving the legal form of a lease* considers whether a leasing agreement meets the definition of a lease in IAS17 *Leases* and how a company should account for any fee that it might receive. A lease is classified as a finance lease if it transfers substantially all the risks and rewards "incident" to ownership. All other leases are classified as operating leases. In this case, the beneficial and legal ownership remains with Electron and Electron can make use of the power station if it so wishes. Also for a lease asset to be a finance lease the present value of the minimum lease payments should be substantially all of the fair value of the leased asset. In this case this amounts to 57.1% (\$40 million ÷ \$70 million) which does not constitute "substantially all". Thus there does not seem to be any issue over the classification of the lease as an operating lease. The immediate recognition as income of the future benefit at net present value is a little more problematical. IAS17 says that lease income from operating leases should be recognised on a straight line basis over the lease term unless another systematic basis is more representative. If a fee is received as an "up front" cash payment then IAS18 *Revenue* (para 20) and SIC27 should be applied. If there is future involvement required to earn the fee, or there are retained risks or risk of the repayment of the fee, or any restrictions on the lessor's use of the asset, then immediate recognition is inappropriate. The present policy of recognising the total lease income as if it were immediate income which it is not, would be difficult to justify. Similarly, as regards the deposit received, revenue should only be recognised when there is performance of the contract. Thus as there has been no performance under the contract, no revenue should be accrued in the period.

Proposed dividend

The dividend was proposed after the balance sheet date and the company, therefore, did not have a liability at the balance sheet date. No provision for the dividend should be recognised. The approval by the directors and the shareholders are enough to create a valid expectation that the payment will be made and give rise to an obligation. However, this occurred after the current year end and, therefore, will be charged against the profits for the year ending 30 June 2007.

The existence of a good record of dividend payments and an established dividend policy does not create a valid expectation or an obligation. However, the proposed dividend will be disclosed in the notes to the financial statements as the directors approved it prior to the authorisation of the financial statements.

Share options

Equity-settled transactions with employees would normally be expensed on the basis of their fair value at the grant date. Fair value should be based on market prices wherever possible. Many shares and share options will not be traded on an active market. In this case, valuation techniques, such as the option pricing model, would be used. IFRS2's objective for equity-based transactions with employees is to determine and recognise compensation costs over the period in which the services are rendered. In this case, the company has granted to employees share options that vest in three years' time on the condition that they remain in the entity's employ for that period. These steps will be taken:

- (i) the fair value of the options will be determined at the date on which they were granted
- (ii) this fair value will be charged to the income statement equally over the three year vesting period with adjustments made at each accounting date to reflect the best estimate of the number of options that eventually will vest

Shareholders' equity will be increased by an amount equal to the income statement charge. The charge in the income statement reflects the number of options that are likely to vest, not the number of options granted or the number of options exercised. If employees decide not to exercise their options because the share price is lower than the exercise price, then no adjustment is made to the income statement. Many employee share option schemes contain conditions that must be met before the employee becomes entitled to the shares or options. These are called vesting conditions and could require, for example, an increase in profit or growth in the entity's share price before the shares vest. In this case the vesting condition is the employment condition. \$940,000 (\$3 million x 94% x 1/3) will be charged in the income statement and to equity at 30 June 2006.

Recommendations and conclusion

The above report sets out the recommendations regarding the accounting treatment of the items specified. It is imperative that the recommendations are followed as non-compliance with a single IFRS constitutes a failure to follow International Financial Reporting Standards for reporting purposes.

Appendix 1

	\$m	\$m
Present value of obligation at 1 July 2005 (15÷1.05)	14.3	
Provision for decommissioning (95% x 14.3)	13.6	
Provision for damage through extraction (5% x 14.3)		0.7

Balance Sheet at 30 June 2006

	\$m	\$m
Tangible non current assets:		
Cost of power station	100	
Provision for decommissioning	13.6	
	113.6	
less depreciation (113.6÷20 years)	(5.7)	
Carrying value	107.9	
Other provisions:		
Provision for decommissioning 1 July 2005	13.6	
Unwinding of discount (13.6x5%)	0.7	
		14.3
Provision for damage (0.7÷20 years)		0.1
		14.4

Income Statement

	\$m
Depreciation	5.7
Provision for damage	0.1
Unwinding of discount (finance cost)	0.7

A simple straight line basis has been used to calculate the required provision for damage. A more complex method could be used whereby the present value of the expected cost of the provision is provided for over 20 years and the discount thereon is unwound over its life.

- 3 (a) Under IFRS, an asset or liability is recognised if it meets the definition of such in the Framework document. The definitions refer to the right to receive or the obligation to transfer economic benefits as a result of a past event. The accounting model used to account for deferred tax is based on the premise that the tax effects of transactions should be recognised in the same period as the transactions themselves. The reality is, however, that tax is paid in accordance with tax legislation when it becomes a legal liability. There is an argument, therefore, that deferred tax is neither asset nor liability.

The temporary difference approach is based on the assumption that an asset will ultimately be recovered or realised by a cash inflow which will enter into the determination of future taxable profits. Thus the tax payable on the realisation of the asset should be provided for. It is argued that it would be inconsistent to represent that the asset can be recovered at its balance sheet value whilst ignoring the tax consequences.

Similarly for a liability carried in the balance sheet, there is an implicit assumption that the liability will ultimately be settled by a cash outflow. The outflow will enter into the determination of tax profits and any tax deduction allowable will effectively be an asset. As above, it would be inconsistent to recognise the liability whilst ignoring the tax consequences of its recognition.

Conceptually there is a weakness in this approach as only one of the liabilities that is tax, is being provided for and not other costs which will be incurred, such as overhead costs. The principal issue in accounting for deferred tax is how to account for the future tax consequences of the future recovery or settlement of the carrying amounts of the assets and liabilities.

(b)		Adjustment to financial statements	Tax base	Temporary difference
	\$'000	\$'000	\$'000	\$'000
Property plant, and equipment	10,000		2,400	7,600
Goodwill	6,000		6,000	
Other intangible assets	5,000		0	5,000
Financial assets (cost)	9,000	1,500	9,000	1,500
Total non-current assets	30,000			
Trade receivables	7,000		7,500	(500)
Other receivables	4,600		5,000	(400)
Cash and cash equivalents	6,700		6,700	–
Total current assets	18,300			
Total assets	48,300			
Long term borrowings	10,000	(400)	10,000	400
Deferred tax liability	3,600		3,600	–
Employee benefits	4,000	520	5,000	480
Current tax liability	3,070		3,070	–
Trade and other payables	5,000		4,000	(1,000)
Total liabilities	25,670			13,080
Share capital	9,000			–
Other reserves	4,500	1,500		
		400		
Retained earnings	9,130	(520)		
Total equity	22,630			
		\$000		
Deferred tax liability 14,980 @ 30%		4,494		
Deferred tax asset (1,900) @ 30%		(570)		
Net deferred tax liability 13,080 @ 30%		3,924		
Less existing liability		(3,600)		
Adjustment to deferred tax		(324)		

- (i) The available for sale investments should be valued at fair value with the increase going to equity (\$1.5 million).
- (ii) The bond should be split into its equity and liability elements as per IAS39.
- (iii) The defined benefit plan should recognise 40% of \$1 million + (60% of \$1 million ÷ 5) ie \$520,000 as an increase in the liability. Retained earnings will be charged with the same amount.
- (iv) As the development costs have been allowed for tax already, it will have a tax base of zero. Goodwill is measured as a residual and, therefore, the impact is not measured under IAS12.
- (v) The accrual for compensation will not be allowed until a later period and, therefore, will reduce the tax base relating to trade and other payables.

4 (a) International Financial Reporting Standards (IFRS) were initially developed for the preparation of group accounts of listed companies. The use of IFRS is growing such that in some countries that are building or improving their accounting regulatory framework, IFRS based corporate reports are deemed to be more reliable and relevant than local GAAP reports. In many of these countries IFRS are the statutory requirement for legal entities and, therefore, an implementation issue that has arisen is that the national law has to be reconciled with the requirements of IFRS.

Another implementation issue relates to small and medium-sized enterprises (SMEs) in terms of whether a separate set of standards should be developed and what should be the underlying conceptual and methodological basis for such standards. Effective implementation requires continuous interaction between the International Accounting Standards Board (IASB) and national regulators. The IASB has issued a draft Memorandum of Understanding on the role of Accounting Standard Setters and their relationship with the IASB. It identifies responsibilities that the IASB and other standard setters should adopt to facilitate the ongoing adoption of or convergence with IFRS.

With the increase in the number of entities applying IFRS, the demand for implementation guidance is growing. The International Financial Reporting Interpretations Committee (IFRIC) has been given the task of meeting this demand but there may be a need for additional coping mechanisms as a limited number of interpretations have been issued since the inception of IFRIC.

Variations in translation of IFRS could introduce inconsistency. In some countries the capacity for highly technical translation is low and there may be a conflict with existing national terminology and legislation. Additionally, time lags in the local “endorsement” process and in translating new IFRS could mean that financial reports may not be consistent with the latest body of standards. Additionally the successful implementation of IFRS will depend upon the robustness of the local regulatory framework. Effective corporate governance practices, high quality auditing standards and practices, and effective enforcement or oversight mechanisms will be required to underpin the IFRs. Often endorsement of the standards is required as part of the implementation process. For example, in the European Union, after IFRS have been issued by the IASB, they must go through an endorsement process before companies listed in the European Union are required to apply them. This process could create standards that differ from those of the IASB.

Implementation of IFRS can have implications for a number of legislative areas. The more complex the regulatory framework, the more problems will arise. There can be tax, price control and company law implications, and certain sectors, such as banking and insurance, may be subject to additional regulation that may require special reporting requirements. Entities may find that they are in breach of existing covenants with lenders where the provision of funding is based on national GAAP ratios. Similarly corporate law may set out the requirements on distribution of dividends and unless the necessary corporate law amendments are made then dividend distributions would be based on national GAAP which might create confusion.

An international mechanism for the co-ordination of enforcement of IFRS is required. IOSCO provides an infrastructure for enforcement with respect to publicly listed companies. IOSCO has put forward proposals for the regulatory interpretation and enforcement of IFRS. On a more local level, the European Union has established the Committee of European Securities Regulators whose role is to improve co-ordination among securities regulators and ensure implementation of legislation in the European Union.

The complex nature of IFRS and the sheer volume of standards make the task of implementation difficult. The standards are deemed to be “principles based” and this may lead to inconsistencies of application, particularly in countries without a critical mass of experienced accountants. Most accountants will have been trained to apply domestic accounting standards, and where there are options in IFRS, then it is likely that the accounting practice closest to their National GAAP will be chosen. Similarly IFRSs utilise fair value measurement extensively and market information is required to more accurately reflect the value. The nature of this market information will vary around the world. If market information is not available, an alternative source can be obtained by simulating a hypothetical market or by using mathematical modelling. Experience of such techniques will vary worldwide, and this experience will be variable in such areas as actuarial estimation, impairment testing, and valuing share based payments. The concepts set out in IFRS may be new to some accounting professionals and may be difficult to grasp.

- (b) Under current accounting practice the objective of acquisition accounting is to reflect the cost of the acquisition. To the extent to which it is not represented by identifiable assets and liabilities (measured at their fair value), goodwill arises and is reported in the financial statements. These exposure drafts adopt a different perspective and require the financial statements to reflect the fair value of the acquired business. The recognition of the acquired business at fair value will mean that any existing interest owned by the acquirer before it gained control will be remeasured at fair value at the date of acquisition with any gain or loss recognised in the income statement.

The proposals treat the group as a single economic entity and any outside equity interest in a subsidiary is treated as part of the overall ownership interest in the group. As a consequence, transactions with minority shareholders are to be treated as equity transactions. No gain or loss will be recognised in the income statement. Accounting for business combinations has to date been based on the “parent entity” concept where the extent of non-controlling interests and transactions with non-controlling interests are separately identified in the primary financial statements.

It is also proposed that goodwill is to be recognised in full even if control is less than 100%. IFRS3 currently requires that goodwill arising on acquisition should only be recognised with respect to the part of the subsidiary undertaking that is attributable to the interest held by the parent entity.

Costs incurred in connection with an acquisition are not to be accounted for as part of the cost of the investment but will be charged in the income statement. There will also be changes to the way in which some assets and liabilities acquired in a business combination are recognised and measured. The draft IFRS requires assets and liabilities acquired to be measured and recognised at fair value at the acquisition date. Currently estimated fair values are used and guidance was given as to how to measure ‘fair value’ in the current standard. This guidance often resulted in the measurement of assets and liabilities in a manner which was inconsistent with fair value objectives.

1	(a)	Operating activities	6
		Retirement benefit	3
		Associate	3
		Subsidiary treatment	4
		Property, plant and equipment	3
		Goodwill	2
		Minority interest	3
		Taxation	3
		Dividend paid	3
		Interest	2
		River	2
		Issue of shares	1
			<u>35</u>
	(b)	Issues	9
			<u>9</u>
	(c)	Ethical discussion	3
		River	3
			<u>3</u>
		AVAILABLE/MAXIMUM	50
			<u>50</u>
2		Oil contracts	4
		Power station	7
		Operating leases	5
		Proposed dividend	3
		Share options	4
		Effective communication	2
			<u>25</u>
		AVAILABLE/MAXIMUM	25
			<u>25</u>
3	(a)	Quality of discussion	2
		Framework	1
		Temporary difference	2
		Liability	1
		Weakness	1
			<u>7</u>
	(b)	Adjustments:	
		Available for sale assets	2
		Convertible bond	2
		Defined benefit plan	2
		Property, plant and equipment	1
	Deferred tax:	Goodwill	1
		Other intangibles	1
		Financial assets	1
		Trade receivables	1
		Other receivables	1
		Long-term borrowings	1
		Employee Benefits	1
		Trade payables	2
	Calculation		3
			<u>19</u>
		AVAILABLE	19
		MAXIMUM	18
			<u>18</u>
		AVAILABLE	26
		MAXIMUM	25
			<u>25</u>
4	(a)	Subjective	18
			<u>18</u>
	(b)	Subjective	7
			<u>7</u>
		AVAILABLE/MAXIMUM	25
			<u>25</u>