SEPH

Monday 20th May2013

5. Financial reporting is constantly changing to meet the practical needs of the evolving business environment in which it operates. One of these changes is the on-going move towards the use of fair value measurements; a change made more urgent by the global financial crisis which emphasised the importance of having common fair value measurement and disclosure requirements – with identical wording – in IFRSs and US GAAP. This evolution has been criticised by the advocates of historical cost who believe there are unresolved issues concerning fair value's reliability and measurement and concerning the current practical use and disclosure of fair value in financial statements. They argue that historic cost provides users with a more useful measure.

   In May 2011 the IASB published IFRS 13 *Fair Value Measurement*. The IFRS establishes a single source of guidance for fair value measurements under IFRS where that is required by other Standards. Its stated objectives are to define fair value, establish a single framework for measuring fair value and require disclosures about fair value measurements. The CEO of Seph, a public limited company, has studied IFRS 13 and is concerned about the changes IFRS 13 will bring to the group's financial reporting practices with respect to the entity's assets and liabilities.

   Required

   a) Advise the CEO of Seph of the main changes introduced by IFRS 13. The CEO is particularly interested in changes to the definition of fair value, measurement and valuation techniques and disclosures.

   [8 marks]

   b) Seph has assumed responsibility for a decommissioning liability in a business combination. This involves the dismantling of an offshore oil platform in 10 years time. Seph would be contractually allowed to transfer the liability to a third party but, due to its unique nature, a quoted price is not available for the amount Seph would be willing to pay to complete the transfer.

      Seph assesses long-term liabilities of this nature on a cost-plus basis by taking into account the future cash outflows that a market participant would be expected to incur to fulfil the obligation. Based upon its experience of fulfilling obligations of this type and on its knowledge of the market, Seph has provided the following data relevant to the measurement of the dismantling obligation:

      (i) Labour costs have been estimated on the basis of current market rates, adjusted for expected increases. There is a 30% probability they will amount to $20 million, a 40% probability they will amount to $25 million and a 30% probability they will amount to $35 million.

      (ii) Industry practice is to allocate overheads and plant operating costs at 90% of expected labour costs.

(iii) The profit mark-up that a third-party contractor would typically require for undertaking the dismantling and assuming the risk associated with the obligation is 20%

(iv) The compensation that a contractor would typically require for the risk that actual cash flows may differ from those expected is 5% of cash flows after inflation.

(v) Based on market and economic forecasts the rate of inflation is estimated to be 4.5% over the ten-year period. The inflation factor to reflect this is 1.553.

(vi) The risk-free rate of interest for a bond maturing in ten years time is 6%. Seph has estimated that a rate of 3% is appropriate to reflect its own credit risk and risk of non performance.

The following present value discount factors are relevant:

Period (years)	3%	6%	9%
10	0.744	0.558	0.422

Required

Advise Seph of the amount to be included in the entity's statement of financial position to reflect the above dismantling obligation. Explain the background to the calculations.

[12 marks]

(Total 20 marks)