Background

Hudson has a year end of 31 December 20X2 and operates a defined benefit scheme for all employees. In addition, the directors of Hudson are paid an annual bonus depending upon the earnings before interest, tax, depreciation and amortisation (EBITDA) of Hudson.

Hudson has been experiencing losses for a number of years and its draft financial statements reflect a small loss for the current year of $10 million.

On 1 May 20X2, Hudson announced that it was restructuring and that it was going to close down division Wye.

A number of redundancies were confirmed as part of this closure with some staff being reallocated to other divisions within Hudson. The directors have approved the restructuring in a formal directors meeting.

Hudson is highly geared and much of its debt is secured on covenants which stipulate that a minimum level of net assets should be maintained.

The directors are concerned that compliance with International Financial Reporting Standards (IFRS® Standards) could have significant implications for their bonus and debt covenants.

Redundancy and settlement costs

Hudson still requires a number of staff to operate division Wye until its final expected closure in early 20X3.

As a consequence, Hudson offered its staff two settlement packages in relation to the curtailment of the defined benefit scheme.

A basic settlement was offered for all staff who leave before the final closure of division Wye. An additional pension contribution was offered for staff who remained in employment until the final closure of division Wye.

The directors of Hudson have only included an adjustment in the financial statements for those staff who left prior to 31 December 20X2.

The directors have included this adjustment within the remeasurement component of the defined benefit scheme.

They do not wish to provide for any other settlement contributions until employment is finally terminated, arguing that an obligation would only arise once the staff were made redundant.

On final termination, the directors intend to include the remaining basic settlement and the additional pension contribution within the remeasurement component.

The directors and accountant are aware that the proposed treatment does not conform to IFRS Standards.

The directors believe that the proposed treatment is justified as it will help Hudson maintain its debt covenant obligations and will therefore be in the best interests of their shareholders who are the primary stakeholder.

The directors have indicated that, should the accountant not agree with their accounting treatment, then he will be replaced.

Tax losses

The directors of Hudson wish to recognise a material deferred tax asset in relation to $250 million of unused trading losses which have accumulated as at 31 December 20X2.

Hudson has budgeted profits for $80 million for the year ended 31 December 20X3. The directors have forecast that profits will grow by 20% each year for the next four years.

The market is currently depressed and sales orders are at a lower level for the first quarter of 20X3 than they were for the same period in any of the previous five years.

Hudson operates under a tax jurisdiction which allows for trading losses to be only carried forward for a maximum of two years.

Required:

(a) Explain why the directors of Hudson are wrong to classify the basic settlement and additional pension contributions as part of the remeasurement component, including an explanation of the correct treatment for each of these items. Also explain how any other restructuring costs should be accounted for. (8 marks)