Chapter 7 Accounting for Provisions, Contingencies and Events after the Reporting Period

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| **LEARNING OBJECTIVES**  1. Define and identify provisions (準備), contingent liabilities (或有負債) and contingent assets (或有資産) (HKAS 37).  2. Explain the requirements of HKAS 37 in relation to the accounting treatment of contingencies in the financial statements and their disclosures.  3. Define events after the reporting period.  4. Identify adjusting and non-adjusting events after the reporting period.  5. Explain the requirements of HKAS 10 in relation to accounting for events after the reporting period and their disclosures. |



**1. Provisions**

**1.1 The nature of provisions**

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| 1.1.1 | Definition |
|  | Provisions are liabilities for which the amount or timing of the expenditure that will be undertaken is uncertain (指時間或金額不確定的負債). |

1.1.2 It believes that provisions are a **sub class of liabilities** and not a separate element of the balance sheet. **Provisions** are **distinguished from other liabilities** **by the uncertainties involved**.

1.1.3 This definition is significant because it means that **provisions must also meet the definition of liabilities**, i.e., **there must be an obligation to transfer economic benefits**. The reasoning behind the main requirements in HKAS 37 is that recognizing a provision for items that are not liabilities would amount to bias rather than prudence and would impair the usefulness of the financial statements.

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| 1.1.4 | Example 1 |
|  | Trade payables are liabilities to pay for goods that have been supplied; however, trade payables are not provision. The terms and conditions, including price and delivery of goods have been formally agreed with the supplier at the time of placing order with the supplier. There should have sufficient certainty regarding the amount and timing of settlement for this transaction. |

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| Question 1 |
| Explain why accruals for electricity are liability but not provisions. |

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| **Solution:** |

**1.2 Scope of HKAS 37**

1.2.1 HKAS 37 does not cover those provisions, contingent liabilities and contingent assets that:

(i) result from financial instruments that are carried at fair values;

(ii) result from executory contracts, except where the contract is onerous;

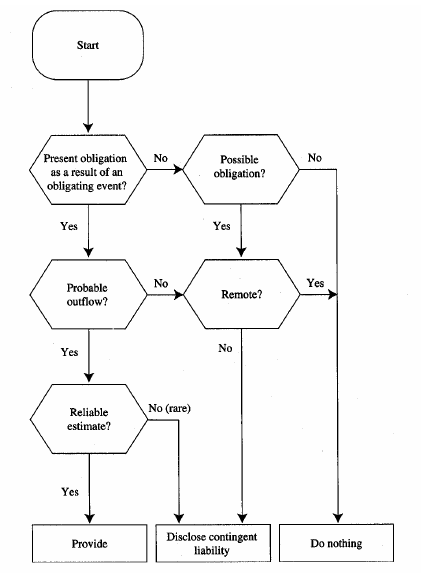
(iii) arise in insurance enterprises from contracts with policyholders; and

(iv) are covered by another HKASs (e.g., HKAS 12, HKAS 11).

**1.3 Recognition criteria**

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| 1.3.1 | Recognition criteria |
|  | A provision should be **recognized** when:  (a) an enterprise has a present obligation (legal or constructive) as a result of a past event (企業因過去事項而承擔項現時的法定或推定義務);  (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation (結算該義務很可能要求含經濟利益的資源流出企業); and (c) a reliable estimate can be made of the amount of the obligation (該義務的金額可以可靠地估計). |

1.3.2 The following decision tree is to summarise the main recognition requirements of the Standard for provisions and contingent liabilities.



(a) First criterion – present obligation as a result of a past event

1.3.3 The present obligation may be:

(a) a **legal obligation** (法律義務), or

(b) **constructive obligation** (推定義務),

where exist when the enterprise has no realistic alternative to settling the obligation created by the event.

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| 1.3.4 | Definitions |
|  | (a) A legal obligation is an obligation that arises from a contract (through its explicit or implicit term), legislation or other operation of law, and the obligation arises only when the legislation is virtually certain to be enacted as drafted. (b) A **present obligation** arising other than from a contract, legislation or other operation of the law is called a constructive obligation. Such obligation **arises from an enterprise’s actions only**, for example, by an **established pattern of past practice or published policies**. The enterprise has indicated to other parties that it will accept certain responsibilities, as a result, the enterprise has **created a valid expectation** on the part of those other parties (e.g. customers, suppliers, employees) that it will discharge those responsibilities. |

1.3.5 The past event that leads to a present obligation is called an **obligating event (負有責任事件)**, i.e., it creates a legal or constructive obligation that **results in an enterprise having no realistic alternative to settling that obligation**. Only those obligations arising from past events existing independently of an enterprise’s future actions that are recognized as provisions.

1.3.6 On the other hand, if the enterprise **can avoid the future outflow of resources embodying economic benefits by its future actions, no obligating event exists and thus no provision should be recognized**. In the past, some enterprises have recognized provisions immediately that the need for a programme of expenditure has been identified, based on grounds of prudence.

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| 1.3.7 | Example 2 – Overhaul costs (obligating events does not exist) |
|  | IJ Airways is required under the legislation of Country R to overhaul its aircraft once every three years. **No provision** for the overhaul costs should be recognized. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise’s future actions. The overhaul expenditure can be **avoided by IJ Airways’ future actions**, say by selling the aircraft, so there is no present obligation for the future expenditure. |

1.3.8 The following examples from HKAS 37, with some modifications, are used for illustration.

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| 1.3.9 | Example 3 – Contaminated land (legal obligation) |
|  | AB Ltd is an oil extracting company. It has been contaminating land in Country W for several years, but there has had no legislation in Country W requiring cleaning up. At 31 December 2016 it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after year-end.Present obligation as a result of a past obligating event – The obligating event is the contamination (污染) of the land because of the virtual certainty of legislation requiring cleaning up.An outflow of resources embodying economic benefits in settlement – Probable. **Conclusion** – A provision is recognised for the best estimate of the costs of the clean-up. |

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| Question 2 – Contaminated land (constructive obligation) |
| CD Ltd. is in the oil industry. It operates in a country where there is no environmental legislation. However, the company has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The enterprise has a record of honouring this published policy.  **Required:**  Discuss whether the provision can be made by CD Ltd? |

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| **Solution:** |

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| 1.3.10 | Example 4 – Closure of a division (no implementation on or before balance sheet date) |
|  | On 16 December 2016 the board of EF Ltd decided to close down a division making a particular product. Before the balance sheet date of 31 December the decision was not communicated to any of those affected and no other steps were taken to implement the decision.  **Present obligation as a result of a past obligating event** – There is no present, constructive, obligation at 31 December 2016, since the decision was not communicated to any of those affected and also the decision has not yet been implemented before the balance sheet date.  **Conclusion** – No provision is recognised. |

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| Question 3 – Closure of a division (communication/implementation before balance sheet date) |
| On 16 December 2016, the board of GH Ltd decided to close down a division. On 20 December 2016 a detailed formal plan for closing down the division was agreed; letter were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.  **Required:**  Discuss whether the provisions can be made by GH Ltd? |

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| **Solution:** |

(b) Second criterion – probable outflow of economic resources embodying economic benefits

1.3.11 An outflow of resources is regarded as **probable** if the outflow is more likely than not to occur (i.e. having a **probability greater than 50%**).

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| 1.3.12 | Example 5 – Warranties (保養) |
|  | MN Ltd gives warranties at the time of sale to purchasers of its product to repair or replace any defects within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.  **Present obligation as a result of a past obligating event** – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.  **An outflow of resources embodying economic benefits in settlement** – Probable for the warranties as a whole.  **Conclusion** – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date. |

(c) Third criterion – reliable estimate of the obligation amount

1.3.13 HKAS 37 states that a sufficiently reliable estimate of the amount of obligation can be made, a provision is to be recognized. Only in extremely rare cases will it be genuinely impossible to make a reliable estimate and a provision exists that cannot be recognized. In this case, that liability should be disclosed as a contingent liability.

**1.4 Measurement**

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| 1.4.1 | Principles of measurement |
|  | (a) The amount recognized as a provision should be the **best estimate** of the expenditure required to settle the obligation that existed at the balance sheet date.  (b) The estimate should take into account:  (i) **risks and uncertainties** associated with the cash flows  (ii) **expected future events** (for example, new technology or new legislation)  (iii) **discounting** whenever the effect of this is material.  (c) If the effect of the time value of money is material, then the provision should be discounted. The **discount rate should be pre-tax and risk specific**. The tax consequences of the provision are dealt with in accordance with HKAS 12 “Accounting for Deferred Tax”.  (d) The **unwinding of the discount is a finance cost**, and it should be disclosed separately on the face of the statement of comprehensive income/income statement.  (e) Provisions should be **reviewed at each reporting date** and adjusted to reflect the current best estimate. |

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| 1.4.2 | Example 6 – Determine the amount of provisions for a large population |
|  | OP Ltd sells goods with a warranty under which customers are covered for the cost of repairs of any defects that become apparent within the first six months after purchase. Based on past experience and future expectation, it is estimated that if minor defects were detected in all goods sold, repair cost of $10 million would result, but if major defects were detected for all the goods sold, repair costs of $40 million would result. The company expects that for the year 75% of the goods sold to have no defect, 20% with minor defects and 5% with major defects.  The amount of provisions for warranties is the expected value of the costs of repairs, $4m (75% × $nil + 20% × $10m + 5% × $40m). |

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| **Question 4**  Nette, a public limited company, manufactures mining equipment and extracts natural gas. Nette has recently ➊ constructed a natural gas extraction facility and commenced production one year ago (1 June 2003). There is an ➋ operating licence given to the company by the government which requires the removal of the facility at the end of its life which is estimated at 20 years. Depreciation is charged on the straight line basis. The cost of the construction of the facility was $200 million and the net present value at 1 June 2003 of the ➌ future costs to be incurred in order to return the extraction site to its original condition are estimated at $50 million (using a discount rate of 5% per annum). 80 per cent of these costs relate to the removal of the facility and 20% relate to the rectification of the damage caused through the extraction of the natural gas. ➍ The auditors have told the company that a provision for decommissioning has to be set up.  **Required:**  Explain with reasons and suitable extracts/computations the accounting treatment of the above situation in the financial statements for the year ended 31 May 2004. (8 marks)  (Adapted ACCA 3.6 Advanced Corporate Reporting June 2004 Q3(b)(i)) |

**1.5 Specific applications in practice**

1.5.1 HKAS 37 further explains how the general recognition and measurement principles for provisions should be applied in three specific cases in practice:

(a) future operating losses;

(b) onerous contracts (負有義務的合約);

(c) environmental provisions; and

(d) restructuring costs.

(a) Future operating losses

1.5.2 In the past, provisions have sometimes been recognized for future operating losses on the grounds of prudence. Now, **no provisions should be recognized for future operating losses**. Those costs could be avoided by the enterprise’s future actions; thus they do not meet the definition of a liability and the general recognition criteria for a provision.

(b) Onerous contracts

1.5.3 An onerous contract is a contract entered into with another party under which the unavoidable costs of fulfilling the terms of the contract exceed any revenues expected to be received from the goods or services supplied and where the entity would have to compensate the other party if it did not fulfill the terms of the contract. The present obligation under an onerous contract should be recognized and measured as a provision.

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| 1.5.4 | Example 7 – Onerous contract |
|  | Droopers plc has recently bought all of the trade, assets and liabilities of Dolittle, an unincorporated business. As part of the take-over all of the combined business’s activities have been relocated at Droopers main site. As a result Dolittle’s premises are now empty and surplus to requirements.  However, just before the acquisition Dolittle had signed a three year lease for their premises at $6,000 per calendar month. At 31 December 2015 this lease had 32 months left to run and the landlord had refused to terminate the lease. A sub-tenant had taken over part of the premises for the rest of the lease at a rent of $2,500 per calendar month.  **Required:**  (a) Should Droopers recognize a provision for an onerous contract in respect of this lease?  (b) Show how this information will be presented in the financial statements for 2015 and 2016. Ignore the time value of money.  **Solution:**  (a) Droopers plc has a legal obligation to pay a further $192,000 ($6,000 × 32 months) to the landlord, as a result of a lease signed before the year end. Therefore an onerous contract exists and must be provided for.  There is also an amount recoverable from the sub-tenant of $80,000 ($2,500 × 32 months). This will be shown separately in the balance sheet as an asset.  The $192,000 payable and the $80,000 recoverable can be netted off in the income statement.  (b)   |  |  |  | | --- | --- | --- | | **Income statement** | 2015 | 2016 | |  | $ | $ | | Provision for onerous contract (net) | 112,000 Dr | - | | Net rental payable on lease (72 – 30) | - | 42,000 Dr | | Release of provision |  | 42,000 Cr | |  | 112,000 Dr | - | |  |  |  | | **Statement of financial position** |  |  | | Receivables |  |  | | Amount recoverable from sub-tenants | 80,000 Dr | 50,000 Dr | | Liabilities |  |  | | Amounts payable on onerous contracts | 192,000 Cr | 120,000 Cr | |

(c) Environmental provisions

1.5.5 Environmental provisions are often referred to as clean-up costs because they usually relate to the cost of decontaminating and restoring an industrial site, when production has ceased.

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| 1.5.6 | Normal rules in HKAS 37 apply |
|  | (a) A provision is **recognized if there is an obligation** (legal or constructive) to repair environmental damage.  (b) **Merely causing damage or intending** to clean-up a site does **not create an obligation**.  (c) An entity **may have constructive obligation** to repair environmental damage. This will be the case if, for example, an entity **publicises policies** that include environmental awareness or explicitly undertakes to clean up the damage caused by its operations.  (d) There **must have been a past obligating event**. A provision can only be set up to rectify environmental damage that has already happened.  (e) The full cost of an environmental provision should be recognized as soon as the obligation arises.  (i) Because it may be many years before the costs relating to the provision are paid out, the **effect of the time value of money is usually material**. Therefore, an environmental provision is normally discounted to its present value.  (ii) If the **expenditure results in future economic benefits**, an **equivalent asset can be recognized**. This is **depreciated over its useful life**, which is the same as the ‘life’ of provision.  (iii) Note that HKAS 37 is silent on whether an asset should be recognized at the same time as a provision. But HKAS 16 Property, Plant and Equipment requires **capitalization of the provision** if it relates to an item of property, etc. |

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| 1.5.7 | Example 8 – Environmental provision cost |
|  | On 1 January 2015, ABC paid the Government of $5m for a three-year licence to quarry gravel. At the end of the licence, ABC must restore the quarry to its natural state. This will cost a further $3m. These costs will be incurred on 1 January 2018. ABC’s cost of capital is 10%.  Explain how this expenditure is treated in the financial statements of ABC.  **Solution:**  ABC has a legal obligation (the obligating event is the taking out of the licence). Therefore, it recognizes a provision for $3m at 1 January 2015. This provision is discounted to its present value.  Each year, the discount unwinds and the provision increases. The unwinding of the discount is charged to profit as a finance cost.   |  |  |  |  |  | | --- | --- | --- | --- | --- | | **Movement on provision** | **2015** | **2016** | **2017** | **2018** | |  | **$000** | **$000** | **$000** | **$000** | | Opening balance | 2,253 | 2,478 | 2,727 | 3,000 | | Finance cost at 10% | 225 | 249 | 273 | - | | Release | - | - | - | (3,000) | | Closing balance | 2,478 | 2,727 | 3,000 | - |   ABC could not carry out its quarrying operation without incurring the clean-up costs. Therefore, **incurring the costs gives it access to future economic benefits**. It includes the additional expenditure in the cost of the licence and recognizes this as an asset. The licence is depreciated over the three years.   |  |  | | --- | --- | | Cost of licence | $000 | | Cash paid 1 January 2015 | 5,000 | | PV of clean-up costs at 1 January 2015 | 2,253 | | Total | 7,253 |   The effect on the financial statements is shown below.   |  |  |  |  |  | | --- | --- | --- | --- | --- | | **Income statement** | **2015** | **2016** | **2017** | **2018** | |  | **$000** | **$000** | **$000** | **$000** | | **Operating costs** |  |  |  |  | | Depreciation (over 3 years) | 2,418 | 2,418 | 2,417 | - | |  |  |  |  |  | | **Finance costs** |  |  |  |  | | Unwinding of discount | 225 | 249 | 273 | - | |  |  |  |  |  | | **Statement of financial position** |  |  |  |  | | **Non-current assets** |  |  |  |  | | Licence: Cost | 7,253 | 7,253 | 7,253 | - | | Accumulated depreciation | (2,418) | (4,836) | (7,253) | - | | Carrying value | 4,835 | 2,417 | - | - | |  |  |  |  |  | | **Liabilities** |  |  |  |  | | Clean-up provision | 2,478 | 2,727 | 3,000 | - | |

(d) Restructuring costs (重組成本)

1.5.8 Restructuring includes terminating a line of business, closure of business locations, changes in management structure, and refocusing a business’s operations.

1.5.9 In the past, provisions have frequently been made for reorganizations and restructuring. Reorganizations may include terminating a line of business, the closure of locations where business is carried on, changes in management structure and cost reduction programmes.

1.5.10 A restructuring is a programme that is planned and controlled by management and has a material effect on:

(a) the scope of a business undertaken by the reporting entity in terms of the products or services it provides, or

(b) the manner in which a business undertaken by the reporting entity is conducted.

1.5.11 It requires that provisions for reorganization/restructuring should be recognized only when an entity is demonstrably committed to the reorganization, i.e., specific actions must have been taken so that others can be expected to act on the basis that the reorganization will proceed and in so doing, leave the entity without realistic possibility of withdrawal.

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| 1.5.12 | Criteria for the provision of restructuring costs |
|  | (a) **Evidence of the commitment** might be:  (i) the public announcement of the detailed plan;  (ii) the commencement of implementation (e.g., dismantling plant, selling assets, notifying external parties and communication to employees);  (iii) other circumstances constructively obliging the entity to complete the reorganization.  (b) The **detailed plan** should identify (**as a minimum**):  (i) the **business** or part of a business concerned;  (ii) the **principal locations** affected;  (iii) the location, function and approximate **number of employees** whose services are to be terminated or duties changed;  (iv) the **expenditures** that will be undertaken; and  (v) the **time** at which the plan will be implemented. Implementation should begin as soon as possible and the period of time to complete implementation should be such that significant changes to the plan are likely.  (c) A **board decision on its own is not a demonstrable commitment**, unless the membership of the Board contains representatives of interests other than management, as is the case in some countries. **Announcement of plans to the public or to employees might constitute commitment**, depending on the level of detail communication. |

1.5.13 Provisions for reorganizations should **include only those expenditures** that are both:

(a) necessarily entailed by a reorganization to which the entity is demonstrably **committed**; and

(b) **not associated with ongoing or new activities of the entity**. Examples of costs that are not allowed include: retraining or relocating continuing staff; investment in new systems and distribution networks, etc., because these expenditures relate to the future operation of the enterprise and are not liabilities for restructuring at the reporting date.

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| 1.5.14 | Example 9 |
|  | On 15 January 2017 the Board of Directors of Shane Ltd voted to proceed with two re-organisation schemes. Shane Ltd’s financial year end is 31 March, and the financial statements will be finalized and published on 30 June. Scheme 1 The closure costs will amount to $125,000. The factory is rented on a short-term lease, and there will be no gains or losses arising on this property. The closure will be announced in June, and will commence in August. Scheme 2 The costs will amount to $45,000 (after crediting $105,000 profit on disposal of certain machines). The closure will take place in July, but redundancy negotiations began with the staff in March.  Explain and calculate the year-end restructuring provision.  **Solution:**  **Scheme 1** – The obligation arises in June, after the year end, and so there will be no provision. However, the announcement in June should be disclosed as an non-adjusting event after the reporting date.  **Scheme 2** – Although the closure will not begin until July, the employees will have had a valid expectation that it would happen when the redundancy negotiations began in March. Therefore a provision should be recognised. The provision will be for $150,000 because the expected profit on disposal cannot be netted off against the expected costs. |

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| Question 5 – Measuring restructuring provisions |
| On 1 October 2016 the Board of MN Ltd resolved to close the loss-making engineering division. A binding agreement to dispose of the assets was signed on 7 October 2016. The sale will be completed on 14 March 2017 at an agreed value of $30 million. The estimated costs of the closure are: redundancy, $2 million; penalty costs for non-completion of contracted orders, $3 million; related professional costs, $1.5 million; losses on the sale of the net assets and liabilities, whose carrying amount at the balance sheet date of 31 December 2016 was $66 million and $20 million respectively; and estimated operating losses for the period from 1 January 2017 to the date of sale, $4.5 million.  **Required:**  **Calculate the provisions MN Ltd should be made.** |

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| **Solution:** |

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| **Question 6**  Wader has decided to close one of its overseas branches. ➊ A board meeting was held on 30 April 2007 when a detailed formal plan was presented to the board. The plan was formalised and accepted at that meeting. ➋ Letters were sent out to customers, suppliers and workers on 15 May 2007 and meetings were held prior to the year end to determine the issues involved in the closure. The plan is to be implemented in June 2007. ➌ The company wishes to provide $8 million for the restructuring but are unsure as to whether this is permissible. Additionally there was an issue raised at one of the meetings. The operations of the branch are to be moved to another country from June 2007 but the ➍ operating lease on the present buildings of the branch is non-cancellable and runs for another two years, until 31 May 2009. ➎ The annual rent of the buildings is $150,000 payable in arrears on 31 May and the lessor has offered to take a ➏ single payment of $270,000 on 31 May 2008 to settle the outstanding amount owing and terminate the lease on that date. Wader has additionally ➐ obtained permission to sublet the building at a rental of $100,000 per year, payable in advance on 1 June. The company needs advice on how to treat the above under HKAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’.  **Required:**  Discuss the accounting treatments of the above items in the financial statements for the year ended 31 May 2007. (7 marks)  Note: a discount rate of 5% should be used where necessary. Candidates should show suitable calculations where necessary.  (ACCA 3.6 Advanced Corporate Reporting June 2007 Q2(d)) |

**2. Contingent Liabilities and Contingent Assets**

**2.1 Contingent liabilities**

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| 2.1.1 | Definition |
|  | A **contingent liabilities** is defined in HKAS 37 as:  (a) a **possible** obligation that **arise from past events** and **whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events** **not wholly within the control of the enterprise**; or  (b) a **present** obligation that **arises from past events** but is **not recognized** because it is **not probable** that an **outflow of resources** embodying economic benefits will be required to settle the obligation; **or the amount** of the **obligation cannot be measured** with sufficient reliability. |

2.1.2 A provision and contingent liability is distinguished on the basis that an enterprise should **never recognize a contingent liability**. However, a contingent liability should be **disclosed in the notes to accounts**, unless the possibility of an outflow of resources embodying economic benefits is remote.

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| 2.1.3 | Example 10 – Contingent liabilities |
|  | (i) Litigation – Pending or threatened litigation needs to be disclosed. The nature of the litigation may take many forms, such as damage to the environment (e.g. polluting air, rivers, etc.)  (ii) Guarantees – Companies often guarantee the liabilities of others. For example, companies (usually within a group) often guarantee each other’s bank borrowings or overdrafts.  (iii) Discounted bills – If the company has discounted bills of exchange with recourse, there is always the possibility that the company will be called upon to honour its promise. |

**2.2 Contingent assets**

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| 2.2.1 | Definition |
|  | A **contingent asset** is defined as a **possible asset** that **arises from past events** and whose **existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events** **not wholly within the control** of the enterprise. |

2.2.2 Contingent assets are **not recognized in financial statements** because to do so could result in the recognition of income that may never be realized. A contingent asset is to be disclosed where an inflow of economic benefits is probable.

2.2.3 The accounting/disclosure requirements are summarized in the following table:

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| **Degree of probability of an outflow/inflow of resources** | **Outflow** | **Inflow** |
| Virtually | Liability | Asset |
| Probable | Liability | Disclose by note |
| Possible | Disclose by note | No disclosure |
| Remote | No disclosure | No disclosure |

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| **Question 7**  Greenie, a public limited company, builds, develops and operates airports. During the financial year to 30 November 2010, a section of an ➊ airport collapsed and as a result several people were hurt. The accident resulted in the closure of the terminal and legal action against Greenie. When the financial statements for the year ended 30 November 2010 were being prepared, the investigation into the accident and the reconstruction of the section of the airport damaged were still in progress and ➋ no legal action had yet been brought in connection with the accident. The ➌ expert report that was to be presented to the civil courts in order to determine the cause of the accident and to assess the respective responsibilities of the various parties involved, was expected in 2011.  ➍ Financial damages arising related to the additional costs and operating losses relating to the unavailability of the building. The nature and extent of the damages, and the details of any compensation payments had yet to be established. The directors of Greenie felt that at present, there was no requirement to record the impact of the accident in the financial statements.  ➎ Compensation agreements had been arranged with the victims, and these claims were all covered by Greenie’s insurance policy. In each case, compensation paid by the insurance company was subject to a waiver of any judicial proceedings against Greenie and its insurers. If any compensation is eventually payable to third parties, this is expected to be covered by the insurance policies.  The directors of Greenie felt that the conditions for recognising a provision or disclosing a contingent liability had not been met. Therefore, ➏ Greenie did not recognise a provision in respect of the accident nor did it disclose any related contingent liability or a note setting out the nature of the accident and potential claims in its financial statements for the year ended 30 November 2010.  **Required:**  Discuss how the above financial transaction should be dealt with in the financial statements of Greenie for the year ended 30 November 2010. (6 marks)  (ACCA P2 Corporate Reporting December 2010 Q3(a)) |

**3. Disclosure Requirements**

**3.1 Provision**

3.1.1 For each class of provision, the following disclosures are required:

(a) a movement schedule reconciling the carrying amount of beginning balance to the carrying amount ending balance for the period, disclosing:

* additional provisions, including increases to existing provisions;
* amounts used (i.e., incurred and charged against the provision);
* unused amounts reversed; and
* the increase in the discounted amount arising from the passage of time and the effect of any change in the discount rate;

(b) a brief description of the nature of the obligation and the expected timing of any resulting outflow of economic resources;

(c) an indication of the uncertainties about the amount or timing of those outflow; and

(d) the amount of any expected reimbursement, starting the amount of any asset that has been recognized for that expected reimbursement.

**3.2 Contingent liability**

3.2.1 Where a contingent liability is disclosed, the enterprise is to provide a brief description of the nature of the contingent liability. In addition, the following information is required:

(a) an estimate of its financial effect;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

**3.3 Contingent asset**

3.3.1 Where a contingent asset is disclosed, the following information is required:

(a) a brief description of the nature of the contingent asset; and

(b) an estimate of its financial effect – where this is not disclosed because it is not practicable to do so, that fact should be stated.

3.3.2 The Tenth Schedule to the Companies Ordinance also requires that where contingencies have not been provided for in the financial statements, the following information should be disclosed:

(a) the general nature of any other contingent liabilities not provided for; and

(b) where practicable, the aggregate amount or estimated amount of those liabilities, if it is material.

**4. Events after the Reporting Period**

**4.1 Definitions**

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| 4.1.1 | Definitions |
|  | (a) Events after the reporting period are those events, both favourable and unfavourable, that occur between the reporting date and the date on which the financial statements are authorized for issue (資產負債表以後發生的事項，是指那些在資產負債表日和財務報表批准公佈日之間發生的有利和不利的事項).  (b) There are two types of such events:  (i) **adjusting events (調整事項)** – those providing further evidence of conditions that existed at the end of the reporting period. These events must be adjusted for in the financial statements.  (ii) **non-adjusting events (非調整事項)** – those that are indicative of conditions that arose after the reporting period. These do not require requirement, but must be disclosed by note or otherwise if material. |

4.1.2 In some cases, an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been issued. In such cases, the **financial statements are authorised for issue on the date of issue**, **not the date when shareholders approve the financial statements**.

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| 4.1.3 | Example 11 |
|  | The management of an entity completes draft financial statements for the year to 31 December 2016 on 28 February 2017. On 18 March 2017, the board of directors reviews the financial statements and authorises them for issue. The entity announces its profit and selected other financial information on 19 March 2017. The financial statements are made available to shareholders and others on 1 April 2017. The shareholders approve the financial statements at their annual meeting on 15 May 2017 and the approved financial statements are then filed with a regulatory body on 17 May 2017.  The financial statements are authorised for issue on 18 March 2015 (date of board authorisation for issue). |

4.1.4 In some cases, the management of an entity is required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. In such cases, the financial statements are authorised for issue when the management authorizes them for issue to the supervisory board.

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| Question 8 |
| On 18 March 2015, the management of an entity authorises financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests. The supervisory board approves the financial statements on 26 March 2015. The financial statements are made available to shareholders and others on 1 April 2015. The shareholders approve the financial statements at their annual meeting on 15 May 2008 and the financial statements are then filed with a regulatory body on 17 May 2015.  When is the date of authorization for the issuance of financial statements? |

**4.2 Examples of adjusting events**

4.2.1 The following examples are normally classified as adjusting events:

(a) Fixed assets – the subsequent determination after the reporting period of the purchase price or sales proceeds of assets purchased or sold before balance sheet date.

(b) Impairment – the receipt of information after the reporting period indicating that an asset was impaired at the balance sheet date.

(c) Provision – the resolution after the reporting period of a court case which, because it confirms that an enterprise already had a present obligation at the balance sheet date, requires an enterprise to recognize a provision.

(d) Profit sharing or bonus payments – the determination after the reporting period of the amount of profit sharing or bonus payments, if an enterprise already had a present obligation at the reporting date to make such payments as a result of event before that date.

(e) Discoveries – the discovery of significant errors or frauds that render the financial statements incorrect or misleading.

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| 4.2.2 | Example 12 |
|  | A major customer went into liquidation on 26 April 2017. The customer’s balance at 31 March 2017 remains unpaid. The receiver has intimated that unsecured payables will receive very little compensation, if any.  **Required:**  Explain how the above matter should be dealt with in the financial statements for the year ended 31 March 2017.  **Solution:**  The major customer went into liquidation 26 April 2017 and it is now clear that this balance is not recoverable. The liquidation is therefore an adjusting event, and the amount of bad debt should be written off in the company’s financial statement for the year ended 31 March 2017. |

**4.3 Examples of non-adjusting events**

4.3.1 The following examples are classified as non-adjusting events:

(a) Business combinations

(b) Restructuring

(c) Discontinuing operations

(d) Purchases or disposal of assets

(e) Fire

(f) Share transactions

(g) Foreign exchange – abnormal large changes in asset prices or foreign exchange rates

(h) Tax – changes in tax rates/laws

(i) Commitments or contingent liabilities

(j) Litigation

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| 4.3.2 | Example 13 |
|  | A fire broke out at the company’s factory on 4 April 2017. This has destroyed the factory’s administration block. Many of the costs incurred as a result of this fire are uninsured.  **Required:**  Explain how the above matter should be dealt with in the financial statements for the year ended 31 March 2017.  **Solution:**  The fire broke out on 4 April 2017, after end of the reporting period of 31 March 2017, so this is an event after the reporting period under HKAS 10. Moreover, there is no evidence of a fire secretly simmering at end of the reporting period and exploding into life on 4 April 2017; the evidence is that there was no fire at 31 March. Therefore, details of the fire should be disclosed in a note to the accounts, so that reader can have a proper understanding of the company’s affairs. |

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| Question 9 |
| HKAS 10 regulates the extent to which events after the reporting period should be reflected in financial statements.  Which of the following lists of such events, which offers after the end of the reporting period but before the approval of financial statements, consists only of items that, according to HKAS 10 should normally be classified as non-adjusting?  1. Insolvency of a debtor whose account receivable was outstanding at end of the reporting period.  2. Issue of shares or loan notes.  3. Changes in foreign exchange rates which relates to sales before end of the reporting period.  4. A major merger with another company.  5. Destruction of a major non-current asset by fire. |

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| **Solution:** |

**4.4 Other related issues**

(a) Date of authorization for issue

4.4.1 An enterprise is required to disclose:

(a) the date when the financial statements were authorized for issue, and

(b) who gave that authorization.

(b) Proposed dividends

4.4.2 Ordinary share dividends that are proposed or declared after the balance sheet date should not be recognized as a liability in the balance sheet. The reason is that such proposed dividends do not meet the recognition criteria of a liability. The enterprise does not have a present obligation at the balance sheet date in respect of dividends proposed or declared after the balance sheet date.

4.4.3 These dividends should be disclosed in a note to the financial statements.

(c) Going concern

4.4.4 HKAS 10 provides that an enterprise should not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the enterprise or to cease trading, or that is has no realistic alternative but to do so.

4.4.5 However, it is important to note that financial statements should not be adjusted where an event after the balance sheet date indicates that the going concern assumption is not appropriate only for part of the enterprise.

**4.5 Disclosure requirements**

(a) Adjusting events

4.5.1 Separate disclosure of adjusting events is not required as they do not more than provide additional evidence in support of items already recognized in the financial statements.

(b) Non-adjusting events

4.5.2 In respect of each non-adjusting post balance sheet event which is required to be disclosed (i.e. material), the following information should be stated by way of notes to the financial statements:

(a) the nature of the event, and

(b) the estimate of the financial effect, or a statement that it is not practicable to make such an estimate.

**Additional Examination Style Questions**

**Question 10**

Darren Company Limited (“DCL”) is engaged in the manufacture of batteries. On the unaudited balance sheet as at 30 June 2008, it has recognised the following provisions as current liabilities:

(a) A provision for late delivery penalty

In May 2008, DCL received a sales order for 7,000,000 units of rechargeable batteries for which the agreed delivery date is 31 August 2008. It is expected that DCL would earn a gross profit of HK$1 per unit. Due to a shortage in the supply of raw materials, at the balance sheet date, the management realised that they could only supply the goods at the earliest on 10 September 2008. According to the sales contract, DCL would compensate the customer for late delivery at HK$0.01 per unit per day.

(b) A provision for annual safety inspection of the production line

The last inspection was carried out in June 2007. Due to a large backlog of sales orders, the management decided to postpone the annual inspection until mid-September 2008.

(c) A provision for the loss on sales of aged finished goods

The products were manufactured in late 2006 with an expected normal usage period of 2 years from the date of production. Due to the short expiry period, they were sold at a price below cost in July 2008.

(d) A provision for bonus payments to two executive directors

In accordance with the directors’ service contract, two executive directors are entitled to receive, in addition to monthly salaries, a bonus of equivalent to 5% of the profit before taxation and the accrued bonus.

**Required:**

**Discuss the appropriateness of the provisions recognized by DCL. (13 marks)**

**(HKICPA QP Module A Financial Reporting February 2008 Q5)**

**Question 11**

XPrint Limited (XP), a printer manufacturer, had the following balances under current liabilities as presented in its annual management accounts as at 31 March 2013:

|  |  |
| --- | --- |
|  | HKD000 |
| Provision for discount coupon | 750 |
| Warranty provision | 5,640 |
| Litigation provision | 8,000 |

XP has developed a new printers model and targets to promote it to its old customers. A letter was issued to 1,500 old customers to offer them a HKD500 discount to exchange the old model for the new one on or before 30 April 2013. It is expected that a profit will still be made at a discounted selling price.

XP provides a one year warranty provision for all the printers it sells. Customers can request a free of charge repair service during the warranty period. A provision of HKD400,000 was made per month. Total expenditure incurred for this service, mainly costs for labour and parts replacement, was HKD3,160,000 during the year, which represented around 0.8% of the sales in the previous year. The ratio for the past five years ranged from 0.64% to 1%. Total sales for the current year amounted to HKD437 million.

XP was named as a defendant in a writ of summons with a statement of claim by another printer producer in relation to the alleged infringement of patent of design, claiming for a sum of HKD9.6 million. XP intended to settle with the plaintiff out of court. An offer letter of HKD3.8 million in compensation was given to the plaintiff in January 2013 and a counter-offer of HKD5 million payable within one month was received in early March 2013. The Board of XP approved to accept the counter-offer of the plaintiff and made the payment on 20 April 2013. The lawyer issued a fee note of HKD650,000 to XP on 1 May 2013 for the relevant legal service provided during the year. Other than the existing HKD8 million provision relating to this case, XP had no other provision.

**Required:**

**(a) Explain and comment the appropriateness of the amount of the provisions recognised in the management accounts at 31 March 2013. (14 marks)**

**(b) The marketing director wrote the following email to the chief financial officer on 29 March 2013: “We just concluded the contract terms of a television advertisement for the new products to be launched in the coming May with a cost of HKD1.8 million. As there was still an un-utilised budget of HKD1.2 million for marketing expenses for this year, I suggest making a partial provision for this expenditure first, please approve.”**

**Do you agree the recognition of the provision at 31 March 2013? (3 marks)**

**(HKICPA QP Module A Financial Reporting December 2013 Q4)**

**Question 12**

Forest Electricity Limited ("FEL") is a manufacturer of electricity appliances which owned two manufacturing plants in the PRC and one retail shop in Hong Kong. FEL has recurred losses in its operation of both manufacturing and retailing businesses. During its financial year ended 31 December 2014, the following transactions have taken place:

**(a)** Due to the poor performance of FEL, the management has decided to terminate the operation of one of the manufacturing plants on 1 December 2014 while they have not yet announced this to all the employees on 31 December 2014. In the year of 2015, it is expected to incur operational costs of HK$8 million, cost of relocation of staff of HK$1 million and dismantling cost of plant of HK$4 million. **(8 marks)**

**(b)** FEL has a long-term supply contract with a customer to provide 100,000 Product X at HK$20 each every year for a term of three years from 1 April 2014 to 31 March 2017. Up to 31 December 2014, FEL has delivered 50,000 Product X to the customer. Because of the increased material costs, the manufacturing cost is expected to be HK$22 each from 1 January 2015 onwards. On 15 December 2014, the management also informed the landlord of the retail shop to terminate the lease of the retail shop as at 31 December 2014. FEL has entered into the non-cancellable leasing arrangement for a term of five years at a monthly rent of HK$80,000. The unexpired lease term is three years from the end of 31 December 2014 and FEL is not allowed to sub-let the retail shop to other parties. **(7 marks)**

**(c)** FEL provides a warranty on Product Y when these products are sold to customers and FEL has also entered into an insurance contract with an insurance company for the reimbursement of these costs. For every defective Product Y, HK$10 per unit will be paid by FEL to the customer while the insurance company would reimburse the same to FEL. FEL sold 800,000 units of Product Y during the year and it is estimated that 10% of these units would have been defective based on the historical pattern. On 15 January 2015, 10,000 units of Product Y are claimed and certified as defective by customers for each of whom the insurance company also reimbursed FEL on the same day. **(5 marks)**

**Required:**

**Advise as to the accounting implications for each of the costs incurred in 2014 and 2015, and calculate the amounts to be recognised for each of the above events by FEL for the year ended 31 December 2014.**

**(20 marks – Approximately 36 Minutes)**

**(HKICPA QP Module A Financial Reporting December 2015 Q6)**

**Question 13 – HKAS 16, HKAS 37 and HKAS 10**

Delta is an entity that prepares financial statements to 31 March each year. During the year ended 31 March 2012 the following events occurred:

(a) On 1 April 2011, Delta purchased some land for $10 million. Delta purchased the land in order to extract minerals from it. During the six months from 1 April 2011 to 30 September 2011, Delta incurred costs totaling $3·5 million in preparing the land and erecting extraction equipment. This process caused some damage to the land. Delta began extracting the minerals on 1 October 2011 and the directors estimate that there are sufficient minerals to enable the site to have a useful economic life of 10 years from that date. Further damage to the land is caused as the minerals are extracted.

Delta is legally obliged to rectify the damage caused by the preparation and mineral extraction. The directors estimate that the costs of this rectification on 30 September 2021 will be as follows:

(i) $3 million to rectify the damage caused by the preparation of the land.

(ii) $200,000 for each year of the extraction process to rectify damage caused by the extraction process itself.

Following this rectification work the land could potentially be sold to a third party for no less than its original cost of $10 million.

An annual discount rate appropriate for this project is 12%. The present value of $1 payable in 10 years’ time with an annual discount rate of 12% is 32·2 cents. The present value of $1 payable in 9½ years’ time with an annual discount rate of 12% is 34·1 cents. (9 marks)

(b) At 31 March 2012, Delta was engaged in a legal dispute with a customer who alleged that Delta had supplied faulty products that caused the customer actual financial loss. The directors of Delta consider that the customer has a 75% chance of succeeding in this action and that the likely outcome should the customer succeed is that the customer would be awarded damages of $1 million. The directors of Delta further believe that the fault in the products was caused by the supply of defective components by one of Delta’s suppliers. Delta has initiated legal action against the supplier and considers there is a 70% chance Delta will receive damages of $800,000 from the supplier. Ignore discounting in this part of the question. (3 marks)

(c) On 10 April 2012, a water leak at one of Delta’s warehouses damaged a consignment of inventory. This inventory had been manufactured prior to 31 March 2012 at a total cost of $800,000. The net realisable value of the inventory prior to the damage was estimated at $960,000. Because of the damage Delta was required to spend a further $150,000 on repairing and re-packaging the inventory. The inventory was sold on 15 May 2012 for proceeds of $900,000. Any adjustment in respect of this event would be regarded by Delta as material. (3 marks)

**Required:**

**Explain and show how the three events would be reported in the financial statements of Delta for the year ended 31 March 2012.**

**(ACCA Diploma in Int’l Financial Reporting June 2012 Q2(a),(c) and (d))**