Chapter 7 Accounting for Provisions, Contingencies and Events after Reporting Date – Answers

**Answer 1**

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Accruals for electricity consumed are liabilities to pay for electricity consumed but have not been paid and invoiced. Although it is necessary to estimate the amount of accruals, the uncertainty is generally much less than for provisions and it is not difficult to estimate our consumption pattern based on the past record.

**Answer 2**

**Present obligation as a result of a past obligating event** – The obligating event is the contamination, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

**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.

**Answer 3**

**Present obligation as a result of a past obligating event** – The communication of the decision to the customers and employees on 20 December gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

**An outflow of resources embodying economic benefits in settlement** – Probable.

**Conclusion** – A provision is recognised for the best estimate of the costs of closing the division.

**Answer 4**

Under HKAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’, a provision should be made at the reporting date for the discounted cost of the removal of the extraction facility because of the following **reasons**:

(i) The installation of the facility 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 (i.e. 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 (HKAS 37 says that only in exceptional circumstances will it not be possible to make some estimate of the obligation).

The cost 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 extraction should not be included in the provision, until the gas is extracted which in this case would be 20% of the total discounted provision. The accounting for the provision is as follows:



Note 2

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 ($10m) is provided for over 20 years and the discount thereon is unwound over its life. This would give a charge in the year of $0·5m + $10m × 5% i.e. $1m.

**Answer 5**

The total provision required for the costs of the closure is determined as follows:

|  |  |  |
| --- | --- | --- |
|  | $m | $m |
| Loss on the sale of net assets |  | 16.0 |
| Related costs |  |  |
| Redundancy | 2.0 |  |
| Penalty | 3.0 |  |
| Professional | 1.5 |  |
|  |  | 6.5 |
|  |  | 22.5 |

The operating losses of $4.5 million in the period from 1 January 2015 until the date of closure cannot be provided for at the date the closure is announced, unless further information is available to prove that the losses arise from an onerous contract.

**Answer 6**

A provision under HKAS 37 ‘Provisions, Contingent Liabilities and Contingent assets’ can only be made in relation to the entity’s restructuring plans where there is both a detailed formal plan in place and the plans have been announced to those affected. The plan should identify areas of the business affected, the impact on employees and the likely cost of the restructuring and the timescale for implementation. There should be a short timescale between communicating the plan and starting to implement it. A provision should not be recognised until a plan is formalised.

A decision to restructure before the balance sheet date is not sufficient in itself for a provision to be recognised. A formal plan should be announced prior to the balance sheet date. A constructive obligation should have arisen. It arises where there has been a detailed formal plan and this has raised a valid expectation in the minds of those affected. The provision should only include direct expenditure arising from the restructuring. Such amounts do not include costs associated with ongoing business operations. Costs of retraining staff or relocating continuing staff or marketing or investment in new systems and distribution networks, are excluded. It seems as though in this case a constructive obligation has arisen as there have been detailed formal plans approved and communicated thus raising valid expectations. The provision can be allowed subject to the exclusion of the costs outlined above.

Although executory contracts are outside HKAS 37, it is permissible to recognise a provision that is onerous. Onerous contracts can result from restructuring plans or on a stand alone basis. A provision should be made for the best estimate of the excess unavoidable costs under the onerous contract. This estimate should assess any likely level of future income from new sources. Thus in this case, the rental income from sub-letting the building should be taken into account. The provision should be recognised in the period in which it was identified and a cost recognised in the income statement. Recognising an onerous contract provision is not a change in accounting policy under HKAS 8 ‘Accounting Policies, Changes in Accounting Estimates and Errors’.

The provision will be the lower of:



Therefore, the provision would be $83,673 as this course of action would be more beneficial to the company.

**Answer 7**

HKAS 37, states that an entity must recognise a provision if, and only if:

(i) a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event),

(ii) payment to settle the obligation is probable (‘more likely than not’), and

(iii) the amount can be estimated reliably.

An obligating event is an event that creates a legal or constructive obligation and, therefore, results in an entity having no realistic alternative but to settle the obligation.

At the date of the financial statements, there was no current obligation for Greenie. In particular, no action had been brought in connection with the accident. It was not yet probable that an outflow of resources would be required to settle the obligation. Thus no provision is required.

Greenie may need to disclose a contingent liability. HKAS 37 defines a contingent liability as:

(a) a possible obligation that has arisen from past events and whose existence will be confirmed by the occurrence or not of uncertain future events; or

(b) a present obligation that has arisen from past events but is not recognised because:

(i) it is not probable that an outflow of resources will occur to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

HKAS 37 requires that entities should not recognise contingent liabilities but should disclose them, unless the possibility of an outflow of economic resources is remote. It appears that Greenie should disclose a contingent liability. The fact that the real nature and extent of the damages, including whether they qualify for compensation and details of any compensation payments remained to be established all indicated the level of uncertainty attaching to the case. The degree of uncertainty is not such that the possibility of an outflow of resource could be considered remote. Had this been the case, no disclosure under HKAS 37 would have been required.

Thus the conditions for establishing a liability are not fulfilled. However, a contingent liability should be disclosed as required by HKAS 37.

The possible recovery of these costs from the insurer give rise to consideration of whether a contingent asset should be disclosed. Given the status of the expert report, any information as to whether judicial involvement is likely will not be available until 2011. Thus this contingent asset is more possible than probable. As such no disclosure of the contingent asset should be included.

**Answer 8**

The financial statements are authorised for issue on 18 March 2015 (date of board authorisation for issue).

**Answer 9**

Items 1 and 3 are adjusting events because further evidence are provided regarding the conditions that existed at the end of the reporting period.

Items 2, 4 and 5 are non-adjusting events because those events are indicative of conditions that arose after the end of the reporting period.

**Answer 10**

**(a)**

Under HKAS 37, a provision should be recognised when and only when:

An entity has a present obligation (legal or constructive) as a result of a past event, and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

According to HKAS 37.19, it is only those obligations arising from past events that exist independently of the reporting entity's future actions that are recognised as provisions.

The provision for the late delivery penalty is a provision for future operating losses as the delivery date of the 7,000,000 units of rechargeable battery is 31 August 2008.

Since the delivery will be expected on 10 September 2008, the compensation per unit will be HK$0.1 per unit (10 days x HK$0.01) and the total compensation will be HK$700,000.

This compensation will reduce the expected gross profit, but will not result in an onerous contract for DCL.

Accordingly, no provision is required for this late delivery penalty as at 30 June 2008.

**(b)**

As at 30 June 2008, DCL has no obligation to perform the safety inspection of the production line, accordingly no provision should be recognised.

The cost for the inspection should be recognised as expense when incurred.

OR

The information provided in the question has not stated whether DCL, by an established pattern of past practice, published policies or a sufficiently specific current statement, has indicated to other parties that it must carry out the safety inspection on an annual basis and therefore, it has created a valid expectation on the other parties in respect of this activity.

If there is evidence to prove the above, this can be considered as a constructive obligation and therefore a provision should be provided.

**(c)**

Any future loss on sales of aged finished goods should be considered in the measurement of the net realisable value of the inventory under HKAS 2 instead of HKAS 37.

The net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Sales of finished goods at a price below the cost immediately after the balance sheet date (July 2008) is a strong indicator of the amount of net realisable value at 30 June 2008.

Accordingly, this should be recorded as a write down of inventories and no separate provision should be recognised in the current liabilities.

**(d)**

DCL has an obligation to pay the bonus to two executive directors in accordance with the directors' service contract.

It should be possible to make a reliable estimate of the provision amount based on the amount of profit before tax and the accrued bonus.

Accordingly, a provision should be recognised as at 30 June 2008.

**Answer 11**

A provision should be recognised when and only when:

* An entity has a present obligation (legal or constructive) as a result of a past event;
* It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
* A reliable estimate can be made of the amount of the obligation.

Provision for discount coupon

XP had the obligation to give the discount upon issue of the letter and before the expiry date.

As XP is still able to make a profit, after the deduction of HKD500, for the sales of the new printer, there are no outflow of resources nor transfer of economic benefits.

It may be possible for XP to make an estimate of number of new sales with the usage of the discount coupon should there have been a similar scheme in the past.

**Conclusion:**

A provision should only be recognised when all the conditions under HKAS 37.14 are met.

No provision should be recognised at 31 March 2013. Accordingly, the provision for the discount coupon of HKD750,000 should be reversed.

Warranty provision

XP has a contractual obligation to provide the free of charge repair service.

XP needs to incur and has incurred the cost for labour and parts replacement for the repair service, there will be a transfer of economic benefits

It is presumed that XP can make an estimate of the amount to be incurred for the provision of the repair service in respect of the product sales made in the year based on the historical performance.

Conclusion:

A provision should be recognised at 31 March 2013.

The amount recognised should be the best estimate of the expenditure recognised to settle the present obligation at the end of the reporting period.

With the presumption that the ratio of expenditure incurred to the sales of the past five years is a reliable estimate of the amount to be incurred for repair services, XP should adjust downward the provision to an amount ranging from HKD2.80 million (HKD437 million × 0.64%) to HKD4.37 million (HKD437 million × 1%).

OR

Assuming 0.8% of the sales is considered to be the best estimate of the amount to be incurred for the repair service, XP can adjust downward to approximately HKD3.5 million (437 million × 0.8%).

Litigation provision

XP is considered to have an obligation to compensate the plaintiff that arises from a past sales transaction.

The compensation of cash payment represents a transfer of economic benefits for XP.

It is presumed that XP could make an estimate of the compensation amount taking into consideration the offer given by XP and counter-offer from the plaintiff approved by the Board.

The payment made in April is an adjusting event after the reporting period.

Conclusion:

The provision should be adjusted downward to HKD5,650,000, i.e. HKD5 million compensation to plaintiff and HKD650,000 legal fee for provided services.

**(b)**

Disagree with the comment.

No provision should be recognised at 31 March 2013 for the cost of television advertising to be launched after the end of the reporting period because:

The agreement is executory and XP had no present obligation (or XP had future obligation only) for the future services to be received from the counter-party.

HKAS 37 does not allow artificial “smoothing” of results by early recognition in the profit or loss before the costs are actually incurred.

**Answer 12**

**(a)**

The closure of the manufacturing plant is one of the events under the definition of restructuring. For the recognition of a provision for a restructuring, two principal requirements to be met are that the entity has a detailed formal plan; and has raised a valid expectation in those affected that the plan will be carried out by starting to implement that plan or by announcing its main features to those affected by it under HKAS 37.72.

Despite the fact that FEL has decided on the closure of one of the manufacturing plants, without a public announcement to all its employees, there is no detailed plan with sufficient details to give rise to valid expectations in other parties that the entity will carry out the restructuring. The management decision to restructure taken on 1 December 2014 is not relevant as FEL has not started to implement the restructuring plan or announced the main features of the restructuring plan to those affected with sufficient detail. Accordingly, FEL should not make any provision as at 31 December 2014 in respect of the restructuring plan.

The operational costs are not liabilities for restructuring at 31 December 2014 as these expenditures are associated with the future conduct of the business. These should be recognised on the same basis as if they arose independently of a restructuring.

A restructuring provision does not include the cost of relocating continuing staff pursuant to HKAS 37.81.

Dismantling plant is a restructuring liability as it is necessarily entailed by the restructuring; and not associated with the ongoing activities of FEL pursuant to HKAS 37.80.

In addition, the decision on the closure of the manufacturing plants is an impairment indicator. The company should perform an impairment test and any impairment loss should be recognised in profit or loss for the year ended 31 December 2014.

**(b)**

An onerous contract is defined as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

As the manufacturing cost per Product X (HK$22) is higher than the revenue per Product X (HK$20), the supply contract is considered to be onerous and a provision should be recognised. FEL should recognise a provision for the onerous contract equal to the expected loss, i.e. HK$2 x 250,000 units of Product X (remaining quantities to be delivered: (100,000 x 3) – 50,000) = HK$500,000.

When FEL has notified the landlord about the early termination of the lease, FEL has established a constructive obligation. FEL should recognise a provision for the onerous contract equal to the non-cancellable lease payment, i.e. HK$80,000 x 36 months = HK$2,880,000.

**(c)**

A provision should be recognised by FEL for the warranty given to customers as past experience shows that it is probable that certain claims would be paid by FEL. The provision should be measured based on the estimation as at 31 December 2014, i.e. HK$10 x 80,000 units of Product Y = HK$800,000.

When there are actual claims from the customers, the payment is recognised as an utilisation of the provision on 15 January 2015.

FEL should not recognise the contingent asset on the reimbursement from the insurance company as at 31 December 2014 as this may result in the recognition of income that may never be realised.

Instead, FEL should recognise the reimbursement income from the insurance company on 15 January 2015 at the amount of HK$10 x 10,000 units of Product Y = HK$100,000 when the realisation of income is virtually certain.

**Answer 13**

**(a)**

Under the principles of HKAS 16 – Property, Plant and Equipment – costs of $13·5 million ($10 million + $3·5 million) will be debited to property, plant and equipment in respect of the cost of acquiring the extraction facility.

The costs of erecting the extraction facility (excluding the land) will be depreciated over a 10-year period, giving a charge in the current period of $175,000 ($3·5 million × 1/10 × 6/12).

From 1 October 2011, an obligation exists to rectify the damage caused by the erection of the extraction facility and this obligation should be provided for.

The amount provided is the present value of the expected future payment, which is $966,000 ($3 million × 0·322).

The amount provided is debited to property, plant and equipment and credited to provisions at 1 October 2011.

The debit to property, plant and equipment creates additional depreciation of $48,300 in the current year ($966,000 × 1/10 × 6/12).

The closing balance in property, plant and equipment is $14,242,700 ($13·5 million – $175,000 + $966,000 – $48,300).

As the date of settlement of the liability draws closer the discount unwinds.

The unwinding of the discount in the current year is $57,960 ($966,000 × 12% × 6/12).

The extraction process itself creates an additional liability based on the damage caused by the reporting date.

The additional amount provided is $34,100 ($200,000 × 6/12 × 0·341).

This additional provision causes an extra charge to the statement of comprehensive income.

The carrying amount of the provision at the year end is $1,058,060 ($966,000 + $57,960 + $34,100).

**(b)**

Under the principles of HKAS 37 – Provisions, Contingent Liabilities and Contingent Assets – a provision should be made for the probable damages payable to the customer.

The amount provided should be the amount Delta would rationally pay to settle the obligation at the reporting date. Ignoring discounting, this is $1 million.

This amount should be credited to liabilities and debited to profit or loss.

Under the principles of HKAS 37 the potential amount receivable from the supplier is a contingent asset.

Contingent assets should not be recognised but should be disclosed where there is a probable future receipt of economic benefits – this is the case for the $800,000 potentially receivable from the supplier.

**(c)**

The event causing the damage to the inventory occurred after the reporting date.

Under the principles of HKAS 10 – Events After the Reporting Date – this is a non-adjusting event as it does not affect conditions at the reporting date.

Non-adjusting events are not recognised in the financial statements, but are disclosed where their effect is material.