FINANCIAL ACCOUNTING 700	DEPARTMENT OF ACCOUNTING
Seminar RS 6 – Suggested solution	
PH Ferreira	UP

SUGGESTED SOLUTION TO QUESTION 1

a. The issue at stake is whether a liability should be raised for each one of these aspects, whether it should only be treated as a contingent liability, or whether no disclosure is required.

A liability is [IAS 37.10]:

- a present obligation of the entity (either legal on constructive);
- arising from past events;
- the settlement of which is expected to result in an outflow of economic benefits.

A provision is a liability of uncertain timing or amount [IAS 37.10].

A provision can only be recognised if [IAS 37.14]:

- an entity has a present obligation as a result of a past event;
- it is probable that there will be an outflow of economic resources; and
- a reasonable estimate of the amount can be made.

Although there is no present obligation in the true sense of the word, it is more likely than not that the claim will succeed. Furthermore the amount can be estimated with reasonable certainty and there is sufficient evidence that an obligation exists to transfer economic benefits as a result of past events. A liability thus exists. A provision should be raised as all requirements for recognition in the financial statements have been met.

b. In this instance, there is no present obligation and a liability therefore does not exist.

The question must thus be asked whether a contingent liability exists.

A contingent liability is [IAS 37.10]:

- a possible obligation 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 entity; or

- a present obligation not recognised because:
  - an outflow of economic benefits is not probable, or
  - the amount can not be measured reliably.

Even though a present obligation does not exist, there is a possible obligation that will only be confirmed by the outcome of a court case in future.

No provision is thus recognised, but the aspect is disclosed by way of a contingent liability note.

c. There is no present obligation, but only a possible obligation. In terms of IAS 37.28 a contingent liability is not disclosed if the possibility of any outflow in settlement is remote, which is the case in this instance. No recognition or disclose is thus required.

SUGGESTED SOLUTION TO QUESTION 2

Accounting treatment

The issue at stake is whether a liability should be raised, whether it should only be treated as a contingent liability, or whether no disclosure is required.

A liability should be recognised as:

- there is a constructive obligation resulting from past events, of which the settlement will result in the outflow of economic benefits [the letters issued by the entity raised a valid expectation with the customers that the defect will be repaired. This repair work will cause an outflow of economic benefits in future];

- there is a probable outflow of economic benefits to settle the obligation [the outflow is beyond any doubt, as the customers have indicated that the arrangement is in order];

- a reasonable estimate of amount is possible [R900 000].

This liability is regarded as a provision because of the uncertainty that exists about the timing and amount of settlement of the obligation - not sure when the customers will bring back the cars and whether everyone will act on the letter. The provision will amount to R900 000.

However, it is expected (virtually certain) that the cost of repairs will be recovered from the reimbursement. A separate asset is recognised for this reimbursement. The amount of the asset may not exceed the amount of the provision. The expense and recoupment may be set-off in the statement of profit or loss and other comprehensive income.

SUGGESTED SOLUTION TO QUESTION 3

PROPOSAL I

Acceptability

IAS 37.63 specifically prohibits provisions to be recognised for future operating losses. Consequently the expected loss of R250 000 in respect of the show activities may not be provided for.

PROPOSAL II

Acceptability

The decision not to disclose relates to the following issues:

- The possible claim falls within the definition of a contingent liability as there is a possible obligation (claim) resulting from past events (alleged breach of patent rights), of which the financial outcome will only be confirmed later by an event outside control of the entity (court case or arbitration).

- The decision of the directors not to disclose, is in conflict with the request for the lawyers to investigate the case. The directors hereby recognise the possibility that the claim may be successful (even though the directors are of the opinion that there is a very slim chance).

- The probability that the contingent loss will realise is apparently small. Consequently only its existence and estimated effect need be disclosed. By doing this the prudence concept is adhered to.

- However, should the board of directors be able to convince the auditor that the probability is remote, nothing need be disclosed.

SUGGESTED SOLUTION TO QUESTION 4

a. The restructuring costs can only be recognised once an obligation (constructive) arises.

   In terms of IAS 37.72 the following requirements need to be met:

   - the entity must have a detailed formal plan for restructuring (requirement met on 12 August) identifying at least:
     - the part of the business concerned;
     - the principal locations affected;
     - the location, function and approximate number of employees that will be compensated for terminating their services;
     - the expenditure that will be undertaken;
     - when the plan will be implemented;

   - the entity has raised valid expectations that the restructuring will be carried out (by starting to implement the plan or by announcing its main feature to those affected by it). This requirement was met when the decision was announced to the employees on 20 August 20X2.

   In this instance, a constructive obligation only arises on 20 August 20X2 when the announcement is made to the employees. The approval by the board does not give rise to a constructive obligation [IAS 37.75].

b. In terms of IAS 37.80 the restructuring provision should only include the direct expenditure arising from the restructuring, which are both:

   - necessarily entailed by the restructuring; and
   - not associated with the ongoing activities.

   Only the contract cancellation costs will therefore qualify for inclusion in the restructuring provision.

   Note that a liability will also be raised for the retrenchment packages, but as employee benefits are excluded from the scope of IAS 37, this liability will be raised in terms of IAS 19.

c. In terms of IAS 37.78 no obligation arises until the entity is committed to the sale, i.e. there is a binding sales agreement. The sale of the assets and the related costs can thus not be recognised until such time. (Adjustments to the carrying amounts of the assets may be required in terms of IAS 36 or IFRS 5 – this will be addressed later in the year).

SUGGESTED SOLUTION TO QUESTION 5

(a) JEFCO LTD

1. Onerous contract

		Dr R	Cr R
31/12/20X2	Expected losses on onerous contract (P/L) [W1]	885 329	
	Provisions (F/P) [W1]		885 329
	(Provision for future loss on onerous contract)		

Reason:

The obligating event is the signed lease contract, which gives rise to a legal obligation.

A lease contract becomes onerous when the unavoidable costs of meeting the obligations exceed the economic benefits.

A provision must be recognised for the best estimate of the net unavoidable costs of meeting the obligations. [IAS 37.68]

2. Environmental restoration costs

		Dr R	Cr R
30/05/20X2	Environmental restoration costs (P/L) [W2]	3 334 906	
	Provision for environmental restoration costs		3 334 906
	(Provision for environmental restoration costs)		
31/12/20X2	Interest paid (P/L) [W2]	179 072	
	Provision for environmental restoration costs		179 072
	(Interest needs to be provided on the outstanding liability)		

At the end of the period the full liability would have been provided for and payment must be debited against the liability.

Reason:

The restoration of the damming and diverting of the river is a legal obligation in terms of the contract.

Jefco Ltd has a constructive obligation to restore the bypass roads. Jefco Ltd has indicated to other parties through its policy and promotions that it accepts the responsibility to clean up and restore the environment.

The obligating event is the contract, the building of the dam and roads and expectations created by the company to restore the environment.

The outflow of resources is probable and a reliable estimate can be made.

3. Audit fees

No journal entries required.

"A provision like all liabilities, should only be recognised when it relates to an event that has already occurred at the reporting date. A contentious issue is the treatment of an audit fee provision. Audit fees should be recognised in the financial year in which audit services are provided, as that is when the obligation to pay the audit firm arises. An audit provision should only relate to work already completed at the reporting date - it should not include a provision for audit work done after the reporting date.

It is sometimes argued that because there is a legal obligation for an audit to be performed for each financial year, provision should be made for the audit fee in the year concerned. We do not believe this argument holds water. There is no obligation for the audit to be performed during the financial year concerned, and the auditor certainly has no claim for fees until the audit work has been done. This is simply another case of a correct interpretation of the recognition criteria overturning a past practice which resulted from prudence and established convention."

Reference: Everingham & Watson, GAAP Newsletter Volume 3 No 1: April 2001.

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(b) JEFCO LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20X2

2. Profit before tax

Profit before tax is shown after the following items have been taken into account:

	R
Expected losses on onerous contract# [W1]	885 329
Environment restoration costs# [W2]	3 334 906

Because of the materiality of these items, it is regarded as separately disclosable items.

3. Provisions

3.1 *Provision for onerous contract*

Carrying amount at beginning of year	-
Provision current year	885 329
Carrying amount at end of year	885 329

Jefco Ltd made provision for an onerous lease contract relating to a retail premises. The lease expires in 30 months on 30 June 20X5. The net unavoidable lease payments are recognised monthly against the provision.

3.2 *Provision for environmental restoration costs*

Carrying amount at beginning of year	-
Provision current year	3 334 906
Interest	179 072
Carrying amount at end of year	3 513 978

Jefco Ltd has a legal as well as a constructive obligation to restore the environment after completion of a construction contract to rebuild bridges in the Limpopo Province. It is estimated that the contract will be completed by 31 July 20X4 where upon the environment will be restored at an estimated cost of R4 050 000.

WORKINGS

W1. Onerous contract

Gross profit per month 2 952 000/12	246 000 p.m.
Remaining period of lease	30 months
Discount rate is	9% p.a.

Cash flow per month

	Lease payments	Gross profit	Net cash flow
Month 1 - 12	(264 825)	246 000	(18 825)
Month 12 - 24	(283 363)	246 000	(37 363)
Month 25 - 30	(303 198)	246 000	(57 198)
Use financial calculator with cash flow functions. Calculate NPV = Net cash outflow. Remember that interest is compounded monthly.			(885 329)

W2. Construction

Number of months to completion of contract (1 June 20X2 - 31 Jul 20X4)	26
Estimated restoration costs (2 200 000 + 1 850 000)	4 050 000
Present value of restoration costs discounted at 9% per annum, compounded monthly at 1 June 20X2	3 334 906
Interest charge on outstanding liability from 1 June 20X2 to 31 December 20X2	179 072*

* Present value of restoration costs at 31 December 20X2 discounted at 9% p.a., compounded monthly: n = 19 (26 - 7), FV = 4 050 000, i = 0,75 (9/12), COMP PV = 3 513 978
∴ Interest from 1 June 20X2 to 31 December 20X2
= 3 513 978 - 3 334 906
= 179 072