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A86045 Accounting and Financial Reporting (2017/2018)

Session 15
Non-Financial Liabilities
(Provisions, Contingent Liabilities and Assets)

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SESSION 15 OVERVIEW AND OBJECTIVES

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Course Objectives

At the end of this course students will be able to:

- ***Read and perform a high level interpretation** of the financial statements of companies applying international accounting standards*
- ***Identify and evaluate** the impact on a companies accounts of alternative accounting methods*
- ***Carry out a high level assessment** of the the economic- financial position of a company reporting under IAS/IFRS.*

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Course Overview

PGS	1. Financial reporting under IFRS	14. Construction contracts	PGS
	2. Financial analysis: Ratio analysis	15. Other Non-financial liabilities	
	3. Financial analysis: Segments and EPS	16. Review session	
	4. Review session	17. Mid term test (Mon April 16)	
	5. Revenues	18. Financial Instruments 1	
	6. Costs and expenses	19. Financial Instruments 2	
	7. Taxation - Direct and Indirect	20. Review session	
	8. Non-current assets - Intangible assets	21. Cash Flow Statement	PT
	9. Non-current assets - Tangible assets	22. Group accounts/Business comb	
	10. Financial leases	23. Review session	
	11. Impairment of assets	24. Review session	
	12. Review session	25. Final test	PGS
PT	13. Inventories		

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Session 15 Overview

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Session Objectives

At the end of this session students will be able to:

1. *Explain the difference between a* ***liability****, a* ***provision*** *and a* ***contingent liability****;*
2. *Articulate the* ***criteria for recording*** *provisions in the financial statements*
3. *Understand the rules for* ***accounting for contingent assets and contingent liabilities***

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Overview of Session 15

- Provisions, contingent liabilities and contingent assets
  - Liabilities
  - Provisions
  - Contingent liabilities
- Restructuring provisions
- Onerous contracts
- Contingent assets

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SESSION 14 RECAP AND PRE-WORK SESSION 15

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Summary of Session 14

Construction contracts

- Types of contract
- Revenues and costs
- Percentage of completion method
- Completed contract method
- Disclosures
- IAS 11 vs IFRS 15

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Session 15 Pre-work

- Reading
  - Melville International Financial Reporting Under IFRS
    - Chapter 10 – Inventories and construction contracts (4th edition)
    - Chapter 13 – Revenues from contract with customers
  - IASB Statements
    - IAS 11 Construction contracts
    - IFRS 15 Revenue from contracts with customers
- Exercises
  - Melville Chapter 10 Ex1 – Ex4 (4th edition)
  - Melville Multiple choice questions Chapter 13
  - EX 14 Construction contracts
- Research
  - RA 12 Provisions: Identify the disclosures in your chosen company in respect of provisions and contingencies.

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DEFINITIONS IAS 37

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Definitions: Liability/Provision

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.

A provision is a liability of uncertain timing or amount.

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation

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Definition/Contingent liability

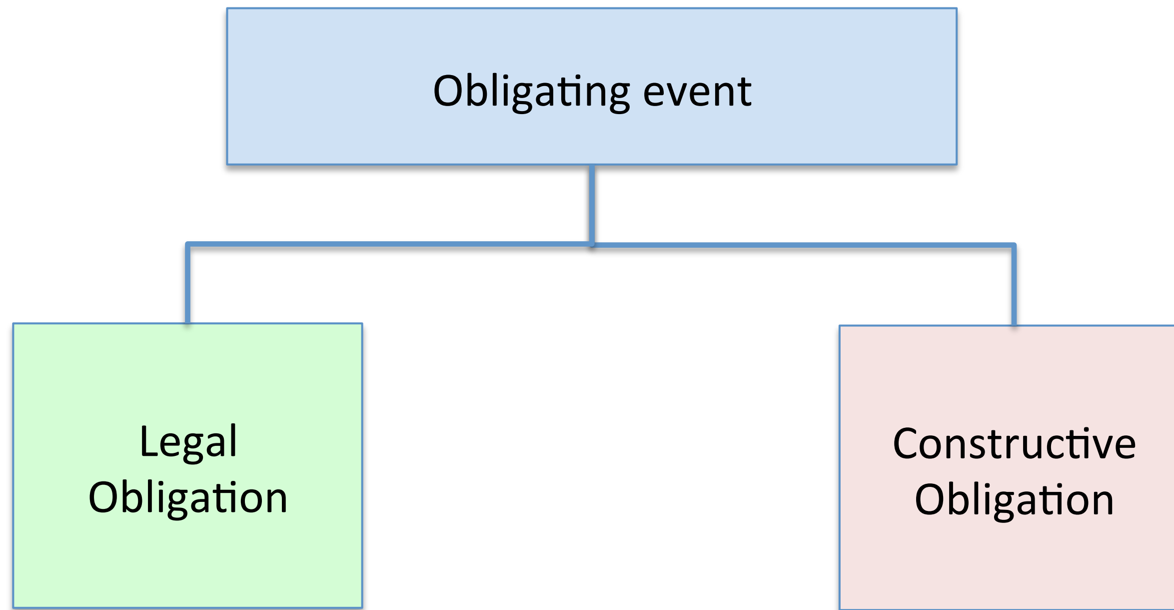
A contingent liability is:

a) 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**

b) A present obligation that arises from past events but is not recognized because:
   i. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
   ii. The amount of the obligation cannot be measured with sufficient reliability.

Obligating events

(A past event leading to a present obligation)



From a contract or by legislation e.g. terms and conditions include a guarantee or warranty.

From an entity's past actions, statements, published policies it has created an expectation it will accept or discharge certain responsibilities. E.g. environmental clean up policies, or restructuring plan communicated

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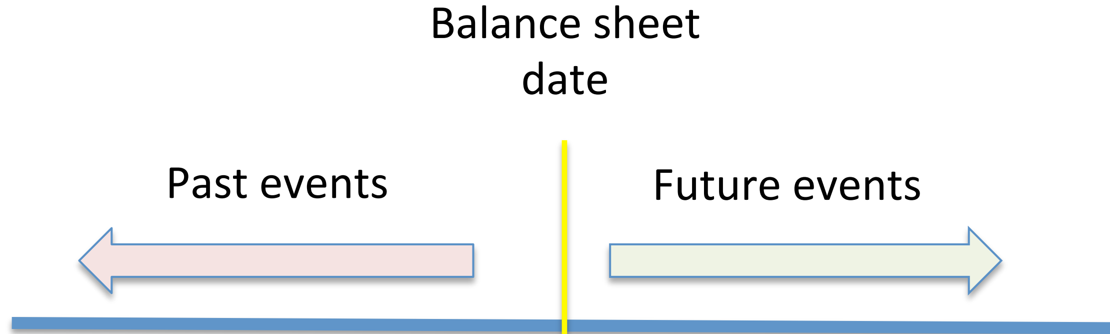
Past event



- Penalties or clean-up costs for unlawful environmental damage
- Decommissioning costs for an oil installation or nuclear power station to the extent that the entity is required to rectify the damage already caused

- For commercial pressures or legal requirements an entity may intend to, or need to, carry out expenditure to operate in a particular way in the future.
- Where proposed new laws have yet to be finalized, an obligation only arises when the legislation is virtually certain to be enacted as drafted

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Example

Under legislation passed in 2012 an entity is required to fix smoke filters in its factories by June 30 2014. The entity has not fitted the smoke filters.

What are the implications for the company ?

a) At December 31, 2013

b) At December 31, 2014

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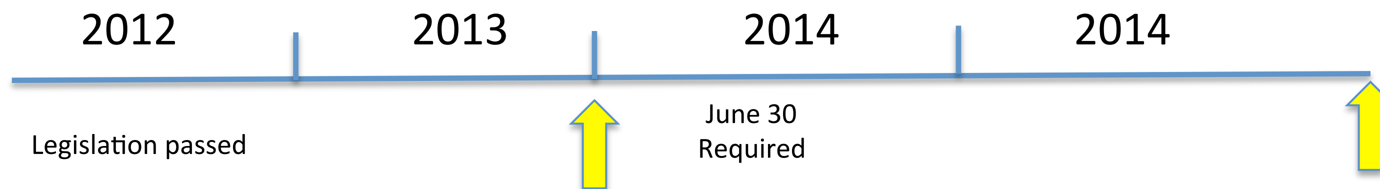
Example

Under legislation passed in 2012 an entity is required to fix smoke filters in its factories by June 30 2014. The entity has not fitted the smoke filters.

a) At December 31, 2013, the end of the reporting period, no event has taken place to create an obligation. Only once the smoke filters are fitted or the legislation takes effect, will there be a present obligation as a result of a past event, either for the cost of fitting the smoke filters or for fines under the legislation.

b) At December 31, 2014 there is still no obligating event to justify provision for the cost of fitting the smoke filters required under the legislation because the filters have not been fitted. However, an obligation may exist as of the reporting date to pay fines or penalties under the legislation because the entity is operating its factory in a non-compliant way. However, a provision would only be recognized for the best estimate of any fines and penalties if, as at December 31, 2014, it is determined to be more likely than not that such fines and penalties will be imposed.

IAS 37 IE 6



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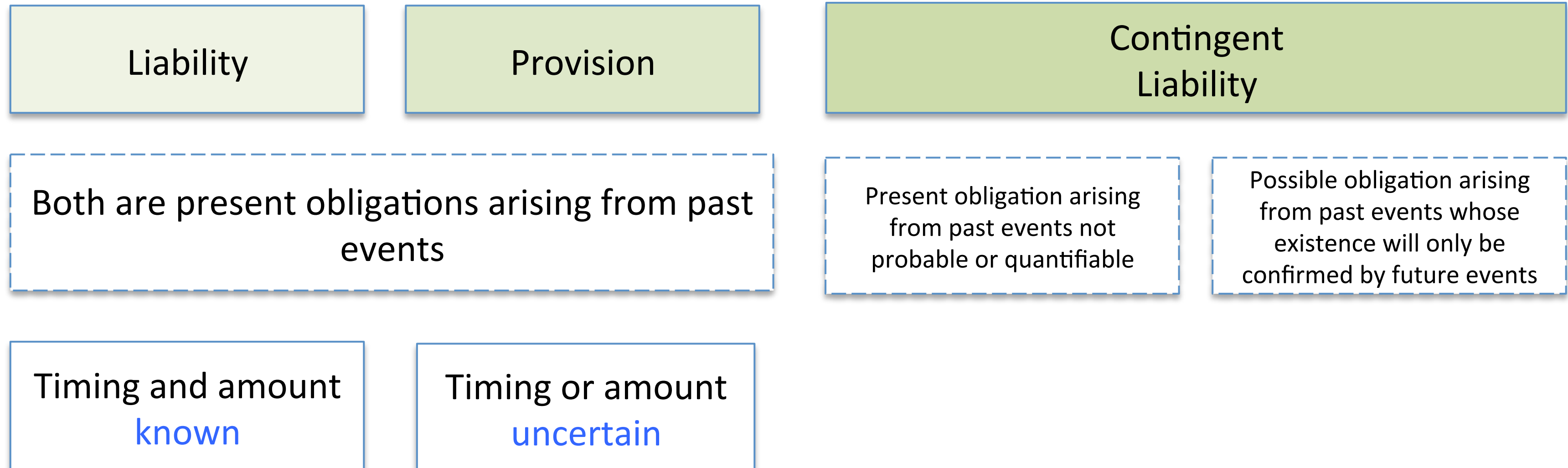
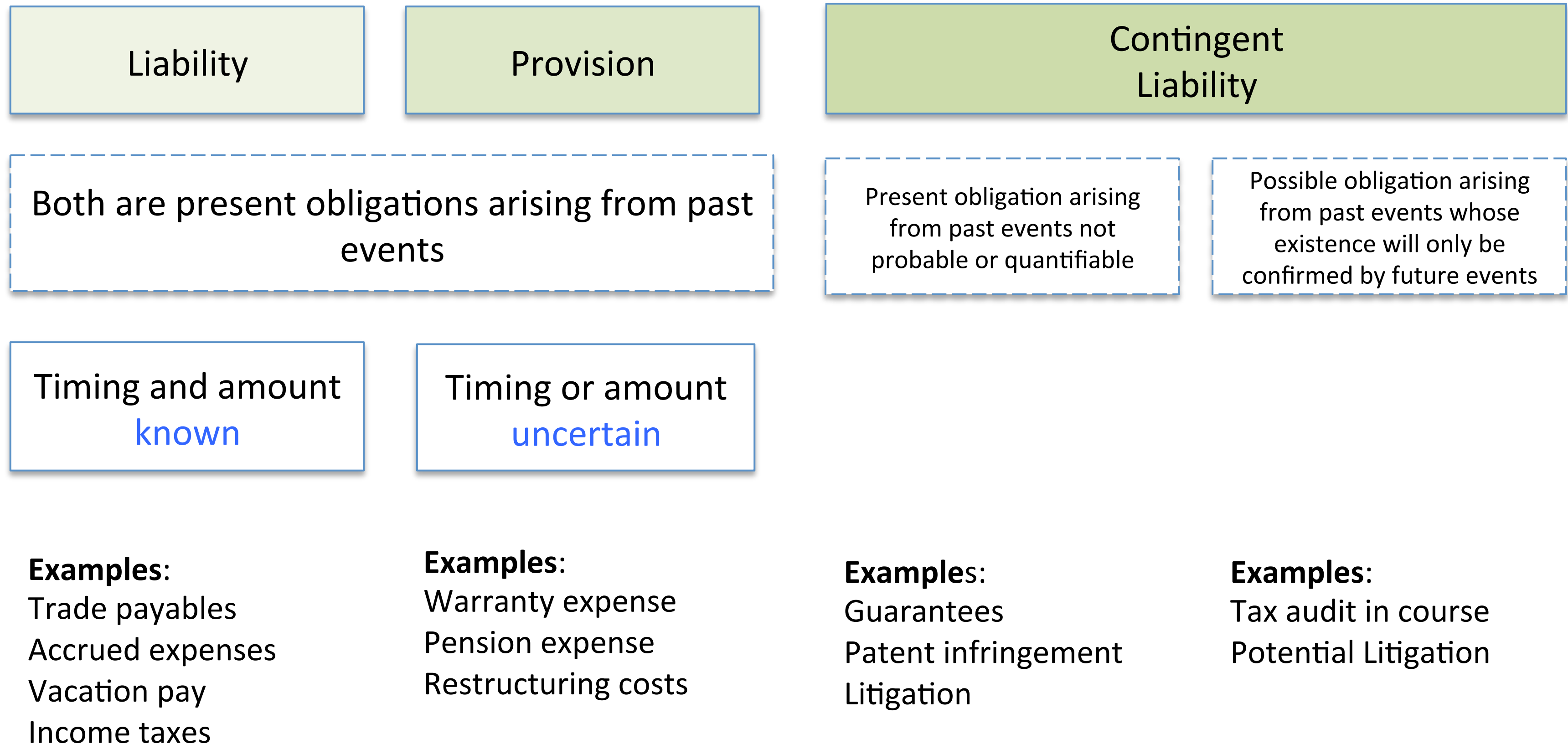
Comparison



Think of some examples of each of these

Comparison



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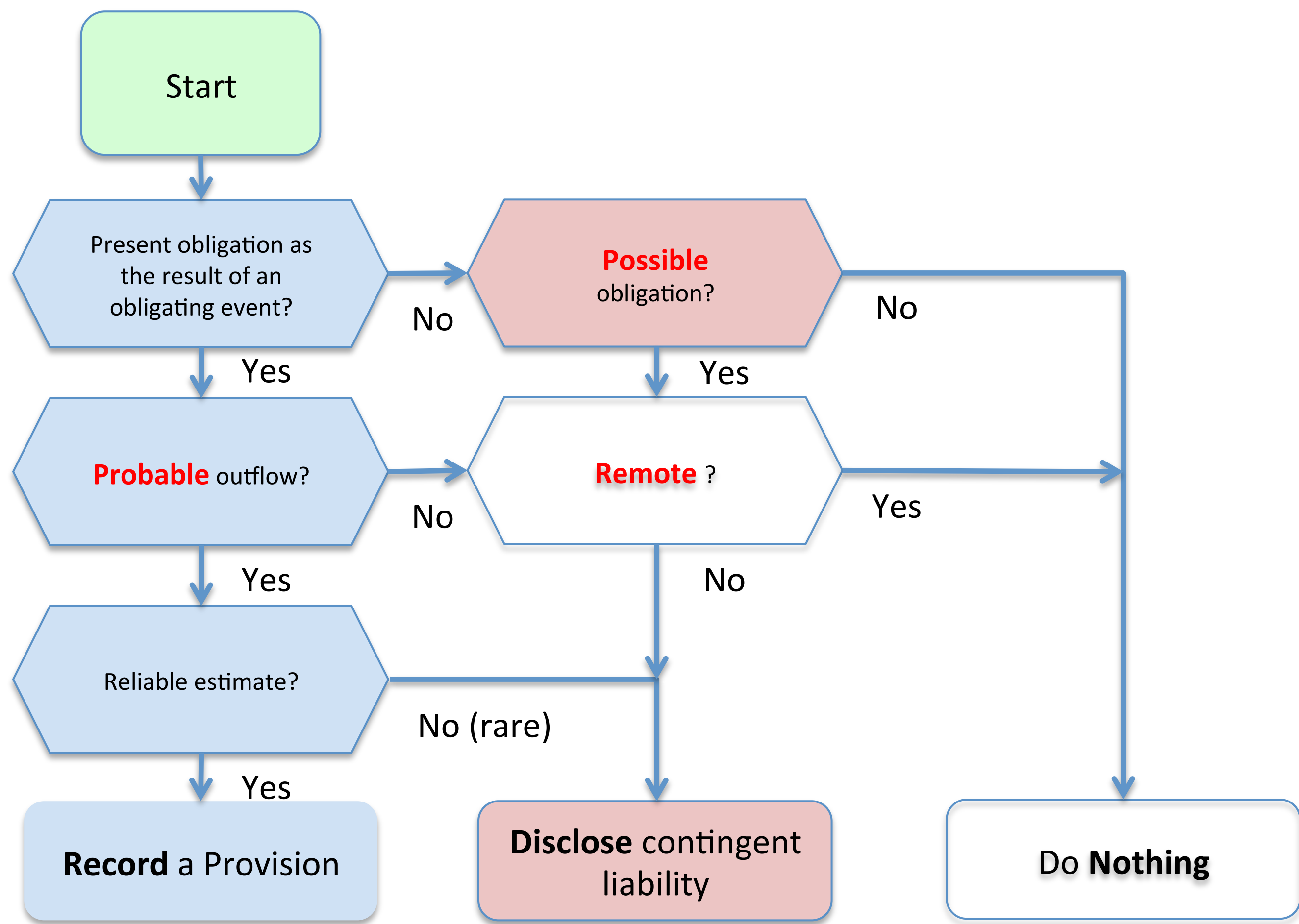
Decision tree



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Probabilities

Likelihood of outcome **(for illustration purposes)**	**Accounting treatment: Contingent liability**	**Accounting treatment: Contingent asset**
Virtually certain (say, >95% probable)	Not a contingent liability, therefore recognize	Not a contingent asset therefore recognize
Probable (say, 50-95% probable)	Not a contingent liability, therefore recognize	Disclose
Possible but not probable (say, 5-50% probable)	Disclose	No disclosure permitted
Remote (say, <5% probable)	No disclosure required	No disclosure permitted

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No provisions allowed for

- Future operating losses – *do not meet the definition of a liability*
- Repairs and maintenance of owned assets - *e.g. major overall or re-fitting*
- Staff training costs – *generally a future cost*
- Rate-regulated activities – *recognition of future performance obligations imposed by a regulator (reduce tariffs or improve services)*

WARRANTIES

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Warranty Provision

A manufacturer gives warranties at the time of sale to purchasers of its products. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

(IAS 37 IE C1)

Should the company record a provision?

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Warranty Provision

A manufacturer gives warranties at the time of sale to purchasers of its products. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years 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 - In these circumstances the obligating event is the sale of the product with a warrant, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - It is more likely than not that there will be an outflow of resources for some claims under the warranties as a whole.

Conclusion - a provision is recognized for the best estimate of the costs of making good under the warranty for those products sold before the end of the reporting period.

(IAS 37 IE C1)

Warranty Example

	Sales	Warranty Provision Expense 1% Sales	Warranty Period/Provision Estimate							
			FY0	FY1	FY2	FY3	FY4	FY5	FY6	FY7
Warranty Period Exposure – 3 Years										
FY0	2.000	20		20	20	20				
FY1	2.500	25			25	25	25			
FY2	3.000	30				30	30	30		
FY3	4.500	45					45	45	45	
FY4	5.000	50						50	50	50
				20	45	75	100	125	95	50
Actual warranty expenses										
FY0		20		6	6	8				
FY1		25			8	8	9			
FY2		30				10	10	10		
FY3		45					15	15	15	
FY4		50						16	16	18
				6	14	26	34	41	31	18
Net warranty provision				14	25	29	40	49	18	0

Do the "T" Accounts to record this

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RESTRUCTURING

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Restructuring

A program that is planned and controlled by management, and materially changes either:

a) The scope of a business undertaken by an entity; or
b) The manner in which that business is conducted

This is said to include:

a) The sale or termination of a line of business
b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another
c) Changes in management structure, for example, eliminating a layer of management; and
d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.

Restructuring

A constructive obligation to restructure arises only when an entity:

a) Has a detailed formal plan for the restructuring identifying at least:
   i. The business or part of business concerned;
   ii. The principal locations affected;
   iii. The location, function, and approximate number of employees who will be compensated for terminating their services;
   iv. The expenditures that will be undertaken; and
   v. When the plan will be implemented; and

b) Has raised valid expectations in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Both aspects need to be in place before the end of the reporting period. The plan in of itself does not give rise to a constructive obligation.

Restructuring – example 1

Closure of a division – no implementation before end of reporting period.

On 12 December 20X0 the board of an entity decided to close down a division. Before the end of the reporting period (31 December 20X0) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

(IAS37 IE 5A)

Should the company record a restructuring provision for the costs associated with closing down the division?

Restructuring – example 1

Closure of a division – no implementation before end of reporting period.

On 12 December 20X0 the board of an entity decided to close down a division. Before the end of the reporting period (31 December 20X0) 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 event – There has been no obligating event and so there is no obligation.

(IAS37 IE 5A)

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Restructuring – example 2

Closure of a division – Communication/implementation before end of reporting period.

On 12 December 20X0 the board of an entity decided to close down a division making a particular product. On 20 December 20X0 a detailed plan for closing down the division was agreed by the board: letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

(IAS37 IE 5A)

Should the company record a restructuring provision for the costs associated with closing down the division?

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Restructuring – example 2

Closure of a division – Communication/implementation before end of reporting period.

On 12 December 20X0 the board of an entity decided to close down a division making a particular product. On 20 December 20X0 a detailed plan for closing down the division was agreed by the board: letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

Present obligation as a result of a past event – The obligating event is the communication of the decision to customers and employees, which 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 recognized at 31 December 20X0 for the best estimate of the costs of closing the division.

(IAS37 IE 5A)

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Restructuring costs

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are **both**:

a) Necessarily entailed by the restructuring; and
b) Not associated with the ongoing activities of the entity

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Restructuring costs - example

On 15 November 2013, management announced its intention to close down its operation in the North of the country and relocate to a new site in the South, primarily to be closer to its key customers. Before the end of the reporting period (31 December 2013) the principal elements of the plan were agreed with employee representatives; a lease signed for a building at the new location; and a notice to vacate the existing facility given to the landlord, all on the basis that production would start at the new location on 31 March 2014 and the existing location would be vacated on 30 April 2014. Production would cease at the existing site on 28 February 2014 to allow plant and equipment to be relocated. Inventory levels would be increased up to that date so that customers could be supplied with goods sent from the Northern facility until 31 March.

Whilst the majority of the 600 existing staff was expected to take redundancy on 28 February 2014, 50 had agreed to accept the entity's offer of relocation, including an incentive of €3,000 each towards relocation costs. Of those employees taking redundancy, 20 had agreed to continue to work for the entity until 30 June 2014, to dismantle plant and equipment at the Northern site; install it at the new facility in the South; and train new staff in its operation. A bonus of €4,500 per employee would be payable if they remained until 30 June. A further 60 had agreed to stay with the entity until 31 March 2014, to ensure that inventory was sent to customers before the new site was operational, of which 10 would remain until 30 April 2014 to complete the decommissioning of the Northern facility. These employees would also receive a bonus for staying until the promised date.

The announcement of management's decision on 15 November 2013 and the fact that the key elements of the plan were understood by employees, customers and the landlord of the Northern site before the end of the reporting period give rise to a constructive obligation that requires a provision to be recognized at 31 December 2013 for the best estimate of the costs of the reorganization. However, only those direct costs of the restructuring not associated with on-going activities can be included in the provision.

Source: International GAAP 2013 EY - Wiley

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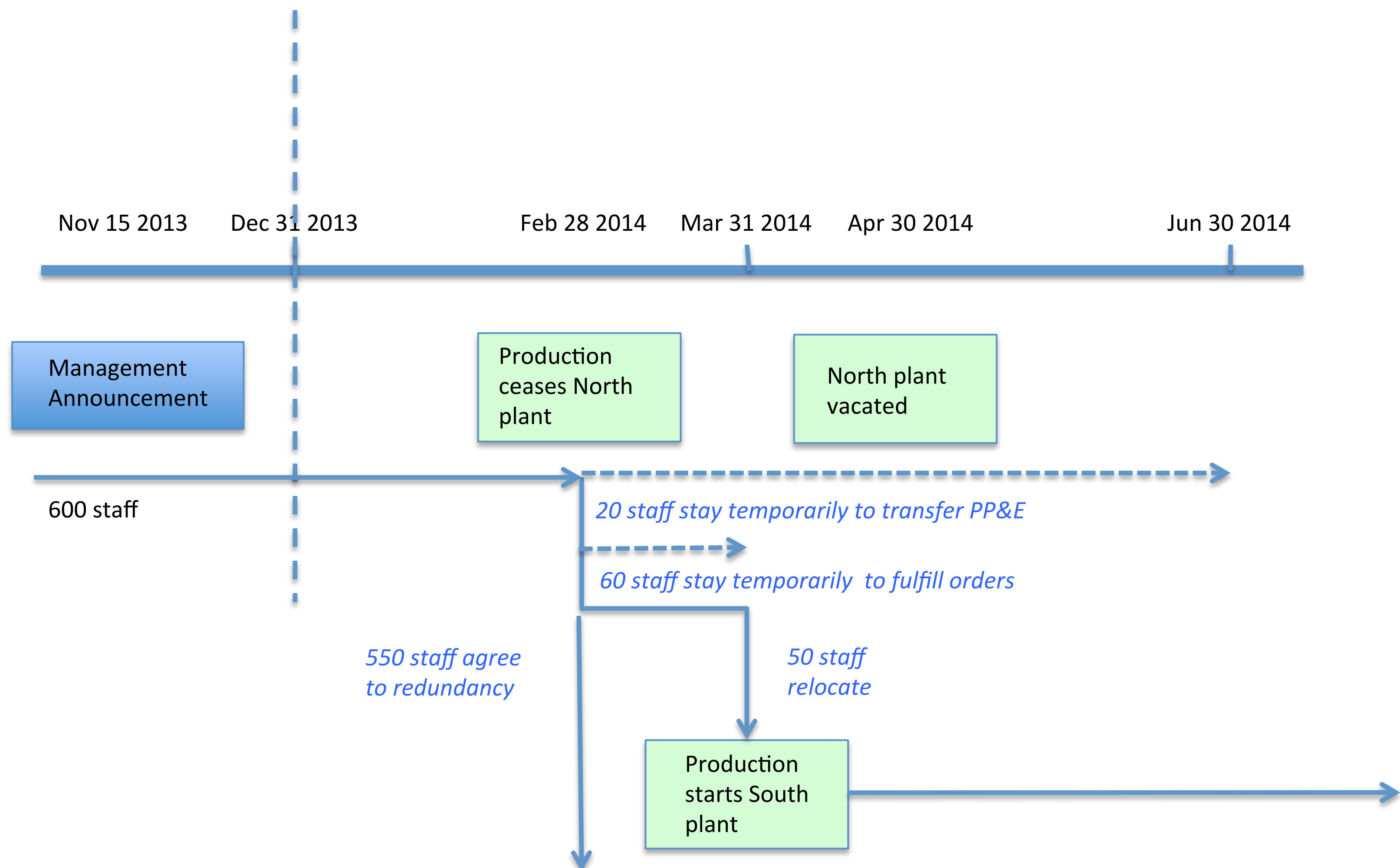
Restructuring costs - example



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Restructuring costs - example

Type of expense	Direct cost of restructuring	Associated with on-going activities
Redundancy payments to 550 staff		
Payroll costs to 28 February 2014 (all 600 staff)		
Relocation incentive of €3,000 per employee (50 staff)		
Payroll costs – to 31 March 2014 (60 staff dispatching goods)		
Payroll costs – March to June 2014 (20 staff relocating plant)		
Payroll costs – April 2014 (10 staff decommissioning site)		
Cost of dismantling plant and equipment		
Cost of transporting PP&E to the new site		
Costs of recruiting and training staff for Southern site		
Rent of Northern site to 31 March 20014		
Rent of Northern site for April 2014		
Cost of terminating lease of Northern site		
Rent of new site to 31 March 2014 (pre-production)		
Cost of invoices, forms and stationery showing new address		

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Restructuring costs - example

Type of expense	Direct cost of restructuring	Associated with on-going activities
Redundancy payments to 550 staff	■	
Payroll costs to 28 February 2014 (all 600 staff)		■
Relocation incentive of €3,000 per employee (50 staff)		■
Payroll costs – to 31 March 2014 (60 staff dispatching goods)		■
Payroll costs – March to June 2014 (20 staff relocating plant) (Note 1)	■	■
Payroll costs – April 2014 (10 staff decommissioning site)	■	
Cost of dismantling plant and equipment (Note 1)	■	■
Cost of transporting PP&E to the new site		■
Costs of recruiting and training staff for Southern site		■
Rent of Northern site to 31 March 20014		■
Rent of Northern site for April 2014	■	
Cost of terminating lease of Northern site	■	
Rent of new site to 31 March 2014 (pre-production)		■
Cost of invoices, forms and stationery showing new address		■

Note 1. Costs relating to dismantling plant and equipment that is no longer intended for use in the business could be regarded as a direct cost of restructuring. However, costs relating to the dismantling and installation of equipment at the new site and training staff to operate it are costs associated with ongoing operations and , therefore ineligible for inclusion in the restructuring provision.

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ONEROUS CONTRACTS

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Onerous Contracts

A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

i.e. the least net cost of exiting the contract, which is the lower of the cost of fulfilling it and any compensation and penalties arising from failure to fulfill it.

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Onerous contract - example

Entity P negotiated a contract in 2010 for the supply of components when availability in the market was scarce. It agreed to purchase 100,000 units per annum for 5 year commencing 1 January 2011 at a price of $20 per unit. Since then, new suppliers have entered the market and the typical price of a component is now $5 per unit. Whilst its activities are still profitable /Entity P makes a margin of $6 per unit of finished product sold) changes to the entity's own business means that it will not use all of the components its has contracted to purchase. As at 31 December 2013, Entity P expects to use 150,000 units in future and has 55,000 units in inventory. The contract requires 200,000 to be purchased before the agreement expires in 2015. If the entity terminates the contract before 2015, compensation of $1 million per year is payable to the supplier. Each finished product contains one unit of the component.

Therefore, the entity expects to achieve a margin of $900,000 (150,000 x $6) on the units it will produce and sell; but will make a loss of $15 ($20 - $5) per unit on each of the 105,000 components (55,000 + 200,000 -150,000) it is left with at the end of 2015 and now expects to sell in the components market.

Onerous contracts - example

	2011	2012	2013	2014	2015		
Quantities contracted	100.000	100.000	100.000	100.000	100.000		
unit price $	20	20	20	20	20		
Purchase commitment $	2.000.000	2.000.000	2.000.000	2.000.000	2.000.000		
Inventory at December 31 2013			55.000				
Additional purchases required			95.000				
Estimated future usage QTY			150.000		255.000	105.000	Commitment less usage
Margin on sales /loss on sales $			6			-15	(Cost 20 less margin 6)
Margin/Loss $			900.000			-1.575.000	-675.000
		Penalty					-1.000.000

In considering the extent to which the contract is onerous, Entity P must compare the net cost of the excess units purchased of $1,575,000 (105,000 x $15) with the related benefits, which includes the profits earned as a result of having a secure source of supply. Therefore the supply contract is onerous (directly loss making) only to the extent of the costs not covered by related revenues, justifying a provision of $675,000 ($1,575,000 - $900,000).

DISMANTLING/DECOMMISSIONING

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Dismantling - example

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10 per cent arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil extracted.

Should the company record a provision at the end of the reporting period?

Dismantling - example

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10 per cent arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil extracted.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement – Probable

Conclusion – A provision is recognized for the best estimate of ninety per cent of the eventual costs that relate to removal of the oil rig and restoration damage caused by building it. These costs are included as part of the cost of the oil rig. The 10 per cent of costs that arise through the extraction of the oil are recognized as a liability when the oil is extracted.

CONTINGENT ASSETS

Contingent asset

A contingent asset is 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 entity.

Contingent assets

Contingent assets are not recognized in financial statements since this may result in the recognition of income that may never be realized. If probable they should be disclosed. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Examples: Claim being pursued through a legal process

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RESEARCH ASSIGNMENT RA 12 PROVISIONS AND CONTINGENCIES

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Research assignment RA 12 Provisions and contingencies

Student Presentations

Provisions & Contingencies Europe's Top 100

	Provisions													Contingencies										
		Disputes				Other																		
	Restructuring	Labour	Commercial	Customs	Antitrust	Onerous Contracts	Restoration	Environment	Spill Response	Taxes	Decommissioning	Product Liability	Guarantees Given	Tax Matters	Warranties	Antitrust	Public Corruption	Labour/ Pensions	Guarantees	Environment	Product Liability	Patent Disputes	Discounted Bills	Business Divestitures
Ab Inbev	•	•	•			•							•	•	•	•		•						
BASF		•	•				•	•					•		•				•					
BAT	•	•																			•			
Bayer	•		•					•		•					•	•					•	•		
BG Group						•					•			•	•		•		•					
BMW		•	•												•				•					
BNP		•															•							•
BP								•	•		•													
Diageo	•			•								•	•											
ENI	•	•	•			•	•	•		•														
GSK	•	•	•											•									•	
H&M																								
HSBC	•		•																•					
Inditex			•																					
L'Oreal	•		•																•					
LVMH	•																		•					
Nestlé	•		•			•		•		•				•				•						
Novartis								•				•				•					•			
Nov Nordisk			•																		•			
Rio Tinto							•	•																
Roche	•		•					•													•			
SAB Miller	•					•				•									•	•				
Sanofi			•					•		•		•				•					•	•		•
Santander			•							•														
SAP	•		•			•	•							•							•	•		
Shell		•	•					•			•													
Siemens			•								•					•	•		•					
Statoil											•			•										
Telefonica	•				•						•					•					•			
Total								•			•								•					
Unilver	•		•							•						•				•				
Vodafone			•								•													
Volkswagen			•													•								

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OVERVIEW, REQUIRED READING AND ASSIGNMENT FOR NEXT SESSION

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Session 16 Overview

- Review Session
  - Leasing examples
  - ?

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Session 16 Pre-work

- Reading
  - Melville International Financial Reporting. A practical guide:
    - Chapter 12 – Provisions and events after the reporting period
  - IASB Statements
    - IAS 37 Provisions, contingent liabilities and contingent assets
- Exercises
  - Melville Chapter 12.1 – 12.7
  - Melville on-line multiple choice questions for Chapter 12
  - EX 15 Non-Financial Liabilities

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SUMMARY AND VALIDATION

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Summary of Session 15

- Liabilities, provisions and contingent liabilities
- Obligating events
- Probabilities
- Warranty provisions
- Restructuring provisions
- Onerous contracts
- Dismantling/Decommissioning provisions
- Industry comparisons

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Session 15 Validation

- What is a provision?
- What is a contingent liability?
- How do we account for a present obligation that is probable but not quantifiable?
- How would we treat a significant potential claim that has not yet been asserted?
- What are the two types of obligating event?
- When can I record a contingent asset?