

Liabilities

OVERVIEW

This is the first of four chapters dealing with liabilities. In it we will discuss the nature of liabilities and how they should be recognised and valued. We will also look at the special type of liabilities known as provisions as well as contingent liabilities and, for convenience, contingent assets. We will deal with accounting for financial instruments, including derivatives, and the special cases of leases and pensions in the following three chapters.

The standards covered in this chapter are

- FRS 12 *Provisions, Contingent Liabilities and Assets* (1998)
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (1998)

Introduction

Liabilities used to be the poor relation in the standard-setting family. When we published the first edition of this book in 1981 the subject did not rate a chapter. Assets were all the rage; liabilities were simply the amounts that the entity owed to be deducted from assets to give the 'net assets'. But the world has changed and now the issue of accounting for liabilities has become one of the more fascinating and complex aspects of accounting theory and practice. Why has this all happened?

The first point to make is that we, and here 'we' encompasses the generality of accountants not just the authors, were wrong. Liabilities were a more important topic than accountants had recognised but far more thinking had been done about the valuation of assets, because it was easier to identify possible different bases of measurement: replacement cost, net realisable value, etc., than was the case with liabilities. But there are other reasons: the last twenty years has seen the introduction or, possibly a more apposite description, the invention of a whole range of far more complex financial instruments, which are often combined with assets and liabilities to create sophisticated financial packages that are capable of bringing to their owners great financial joy or total financial devastation. The language of accounting has changed; words and phrases like *derivatives* and *hedge accounting*, both of which we will discuss in the next chapter, have moved from the periphery to the centre of the profession's lexicon.

The forced liquidation of companies because of their inability to pay their debts is not a new phenomenon. Indeed, much of the early history of the accountancy profession was concerned with liquidations. However, while not discounting some of the spectacular failures of the Victorian era, we are all aware that modern disasters are getting bigger and worse and hence there is the need for users of financial statements to be supplied with appropriate information that will help them form a view as to the financial viability of entities. But the decisions as to the nature of information that should be supplied are still largely based on opinion, for there is even less coherence in the attempts to devise a theory of accounting for

liabilities than has been achieved in the corresponding debate about assets. The liabilities debate is, however, starting to take off and we shall refer to some its strands in the course of this and the following chapters.

The debate associated with the treatment of various aspects of liabilities has intensified in recent years, both internationally and locally, for the countries that are members of the European Union. The convergence programme, which we discussed in Chapter 3, is increasing its pace and is now involving areas, like liabilities, where there has been a relative lack of conceptual thinking. As far as EU members are concerned, the game is becoming even more heated since the promulgation of the EU Regulation which requires that from 1 January 2005 all listed companies in the EU will have to prepare their consolidated financial statements in accordance with international standards.¹

The three sources of funding

A company acquires capital funding through three sources:

- from owners – through either direct contribution of share capital or the retention of profits
- by borrowing
- through gifts.

The last named might seem an unusual source but in fact governments and other agencies do make significant contributions to some companies. Let us start with these.

Grants and gifts

We discussed the subject of accounting for government grants in Chapter 6 where we pointed out that a logical case could be made for retaining on the balance sheet a section, separate from owners' equity and liabilities, representing the volume of funds that have been provided by government and similar agencies. However, as we pointed out, SSAP 4 *Accounting for government grants*, does not take this line. Instead the standard requires that the government grant should be credited to the profit and loss account either immediately or over time. Hence, a transfer is made between the 'gift' source of finance and shareholders' funds; the grant is thus treated as a gift to the owners rather than to the business itself. A more unusual form of gift is sometimes found in small family-owned businesses where a very long-term loan is granted, possibly interest free, where, under foreseeable circumstances, there is no intention that the loan should be repaid. In such, admittedly rare, cases the source of finance would be treated as a liability.

Debt and equity

The two other sources of funding are referred to as debt (or liabilities) and equity. Debt, or liabilities, are the resources provided by outsiders and equity comprises the resources provided by the owners of a company. The use of the word equity to describe the source of funds provided by owners can sometimes lead to confusion, because it is narrower than the term shareholders. In the context of companies with share capital, there may be both equity shares and non-equity shares, such as preference shares, in issue. As we shall see, the latter

¹ See Chapter 3.

shares are usually more appropriately described as liabilities than equity, the latter term being restricted to the owners who hold the residual interest in the income and capital of the company.

In the sections that follow it will be necessary to consider the nature of the accounting problems that have to be faced when considering liabilities. These are recognition, measurement, presentation and disclosure.

Recognition

The fundamental questions are when has the entity made a commitment that falls to be recognised in the financial statements and when has it discharged that commitment so that the liability can be removed from the balance sheet?

Measurement

Once a liability is to be recognised, at what amount should it be recognised in the balance sheet? A related question is the measurement of the expense relating to the liability and deciding on the period in which it should be charged in the financial statements.

Presentation

Presentation covers such things as where, in the financial statements, a liability should appear as well as where changes in the value of the liabilities should be disclosed, whether in the profit and loss account or the statement of total recognised gains and losses. In some ways, presentation is not a good description of the issues dealt with under this heading because they include matters such as the distinction between long-term creditors, short-term creditors and provisions as well as that between debt and equity. Perhaps a better description would be presentation and classification.

Disclosure

This is concerned with what information should be disclosed and how it should be disclosed.

Liabilities

The nature of liabilities

We should start by considering what the basic nature of liability is, and where better to start than with the *Statement of Principles for Financial Reporting* that provided the following definition:

Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events. (Para. 4.23)

The concepts involved are straightforward. Perhaps the key word in the definition is 'obligations'. A liability only exists when the entity cannot avoid the future transfer of economic benefit – which might take the form of cash or the provision of goods or services. The word obligation is not, in this context, always capable of objective interpretation. There can be no doubt about the nature of a legal or contractual obligation but there may be other circumstances where the entity has no realistic alternative other than to transfer economic benefit. An example could be a business that may, for commercial considerations, have no realistic alternative to refunding the price of goods that fail to meet the expectations of customers,

even though it has no legal obligation to do so. Such obligations, which are not legally binding, are often termed *constructive obligations*.

Ownership interest or equity is the residual amount found by deducting all the entity's liabilities from all of the entity's assets. (Para. 4.37)

The *Statement of Principles* goes on to make a point that is obvious but which is worth restating, that owners, unlike creditors, do not have the ability to insist that a transfer is made to them regardless of the circumstances.

The recognition of liabilities

UK financial reporting standards are remarkably silent on the topic of the recognition and derecognition of liabilities; the topic is not addressed in FRS 4, *Capital instruments* (see Chapter 8), which tacitly assumes that there will be no difficulty in deciding whether something should be recognised and is more concerned with whether the item represents debt or equity. The only standard that directly addresses the recognition or derecognition of liabilities is FRS 5 *Reporting the Substance of Transactions*. This states at Para. 20:

Where a transaction results in an item that meets the definition of an asset or liability, that item should be recognised in the balance sheet if –

- (a) there is sufficient evidence of the existence of the item (including, where appropriate, evidence that a future inflow or outflow of benefit will occur), and
- (b) the item can be measured at a monetary amount with sufficient reliability.

This is in line with the criteria for recognition specified in the ASB *Statement of Principles*, which were discussed in Chapter 1.²

The FRS 5 definition of a liability is that one exists if there are circumstance in which the entity is unable to avoid, legally or commercially, an outflow of benefits. This seems a very straightforward and sensible approach but, as we will see later it is proving to be one of the more difficult areas to resolve in the convergence programme.

The measurement of liabilities

We will discuss the measurement of financial liabilities and liabilities that have a market value in the following chapters and so at this stage we will focus on the measurement of liabilities arising from the obligation to provide goods and services where, typically, the customer has paid in advance. We will also use this part of the chapter to provide an introduction to a theoretical model of measuring the value of a liability, that is referred as the relief value approach. We will in this section draw heavily on an ASB 'exploratory essay', the first and so far the only one publications of this type to be published by the Board, written by Andrew Lennard and entitled, *Liabilities and how to account for them*.³

² FRS 5 *Reporting the Substance of Transactions*, Para. 18. The subject of the recognition of liabilities is also of course covered in the *Statement of Principles for Financial Reporting* but the discussion is mostly about the nature of evidence; it does not change the basic notion that a liability exists when benefits flow out of the entity.

³ *Liabilities and how to account for them*, ASB Oct. 2002. The publication carries the disclaimer that it represents the views of the author and not the Board and that there are no plans to develop proposals for an accounting standard directly from the paper.

The simple example on which much of the argument of the paper is based is that of a business that receives in advance a non-refundable fee of £100 to perform a service that it believes that will cost £60 to discharge. Until the obligation is discharged, the business has a liability, but at what value should it appear in the balance sheet? Some have argued⁴ that there might be circumstances (strong confidence that the work can be completed for £60 would be an important condition) in which the liability would be shown at £60 with profit of £40 being recognised immediately. This would be consistent with the view that in very special circumstances, the making of the sale is the ‘critical event’ in the transaction.

It may, at this stage, be helpful to consider how, in the absence of accounting rules, the liability might be measured if we removed the assumption of certainty. In such a case the liability could be measured on the basis of the best estimate of what it would cost to discharge the order. Such an approach is not purely theoretical because, if another business were to offer to discharge the service on behalf of the original supplier, that estimate would provide the benchmark against which the offer might be judged; if the proposed price is less than the estimated cost of providing the service then, all other things being equal, the offer is worth accepting.⁵ An approach on these lines would measure the liability on the basis of its settlement value, where settlement value is analogous to exit values as applied to assets. Lennard argues strongly against the use of settlement values as the basis of the measurement of liabilities. He believes that the purchase consideration, in this case £100, represents the minimum figure at which the liability should be stated because this ‘ensures that future (“unearned”) returns are not anticipated, but are reflected only when they arise, on settlement of the liability’.⁶

Such an approach places emphasis on the timing of the recognition of revenue rather than on an economic assessment of the value of the liability. This is clear later in the paper where Lennard goes on to argue that, while the financial statements should be useful in predicting future cash flows, they should not consist of representations of future cash flows.⁷

Let us accept Lennard’s argument for a moment and consider the situations where the liability would be stated in excess of the floor value of £100. This will occur if it becomes apparent that the contract has become onerous, in that it is now expected to cost more than £100 to fulfil. In such a case the business has a choice: it could seek to be released from the contract or grit its teeth and suffer the loss. Then, again ignoring legal issues and possible long-term consequences, it will select the least costly of these two options. Hence, Lennard argues that the liability should generally be measured by reference to the consideration but in some circumstances, such as onerous contracts, it should be measured at the lower of the cost of performance and the cost of release.

In other words the relief value of the liability to the business is found from the formulation in Figure 7.1.

This formulation is the counterpart of the definition of the ‘value to the business’ of the asset, see Figure 1.3, where consideration is the equivalent of replacement cost, settlement amount being akin to recoverable amount and cost of performance and cost of release replacing value in use and net realisable value.⁸

There is, however, one major difference between the two definitions. The ‘value to the business’ measure, or to give its alternative name ‘deprival value’, shows the amount the

⁴ Richard A. Samuelson, ‘Accounting for Liabilities to Perform Services’, *Accounting Horizons*, Vol. 7, No. 3, 1993.

⁵ We have here ignored any legal complications that may arise from the possible switch of supplier as we have any possible damage to the reputation of the original supplier.

⁶ A. Lennard, *Liabilities and how to account for them*, London, ASB, 2002, para. 24.

⁷ *Op. cit.* para. 87.

⁸ A very much earlier formulation of relief value was provided by W.T. Baxter, *Accounting Values and Inflation*, Maidenhead, McGraw-Hill, 1975.

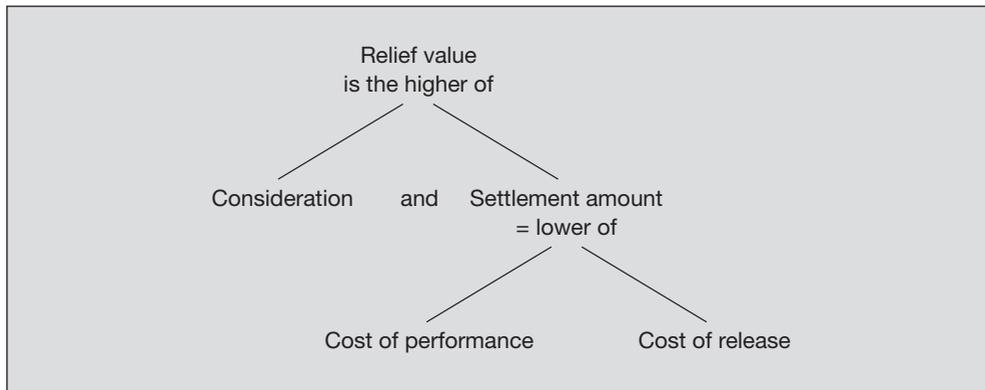


Figure 7.1 Relief value of the liability to the business

entity would need to receive, should it be deprived of the asset, to make it as well off as it was before the loss. Can the same be said about relief value? It seems not. To return to our simple example, if a fairy godmother waved a magic wand and made the liability disappear how much better off would the business be, or in other words how much should they be prepared to pay the fairy to cast her spell? The answer is the amount that the business would not then be required to pay, which is the expected cost of providing the goods or service, and not the original consideration of £100.

The question of how to measure liabilities for services and the associated question of when to recognise revenue is likely to continue for some time.

Provisions and contingencies

Provisions and contingent items are bound up with doubt and uncertainty. There may be no doubt that a provision is a liability – something is owed or an obligation has to be discharged – but there may be doubt as to how much is owed or when it has to be paid. In the case of a contingent asset or liability there may be doubt as to whether the thing exists at all. Doubt and uncertainty very easily give rise to uneven accounting treatment and, as we shall show, prior to the intervention of the ASB, this was particularly true in the case of provisions and, to a lesser extent (because the ASC had published SSAP 18 *Accounting for Contingencies*) in the case of contingent assets and liabilities. The ASB issued a Discussion Paper in November 1995 and an Exposure Draft, FRED 14, in June 1997 which was followed by FRS 12 *Provisions, Contingent Liabilities and Assets* in September 1998.

FRS 12 Provisions, Contingent Liabilities and Assets

We deal first with provisions and then go on to consider contingent liabilities and assets, the last named being included in a standard which is largely devoted to liabilities because the treatment of contingent assets and contingent liabilities share many common features.

The need for a standard

It had long been recognised that there was considerable variation in the treatment of provisions. For example, provisions were almost always recognised when there was likely to be expenditure resulting from goods sold under warranty, whereas they were far less frequently recognised in the case of potential environmental liabilities. But there was more to the problem than inconsistent practice: the lack of clarity allowed accountants to manipulate the figures for profit.

If provisions can be related to intention ('we think we will do this') rather than obligation ('we must do this') it would be possible to smooth profits by creating provisions in years in which the profit is high and releasing them in years in which profits are low (using the defence that 'we changed our mind').

Another way of apparently creating a healthy growth in profits was to engage in 'big bath' accounting. This often occurred following an acquisition of a new subsidiary or in a reorganisation of some kind, possibly following a change in management after disappointing financial results. The profit and loss account was charged not only with committed expenditure but also with planned expenditure for several years. The failure of users of financial statements to understand the significance of excess provisions and its beneficial effect on the reported profits of the years following the acquisition or reorganisation helped to boost the careers of a number of so-called 'company doctors'.

FRS 12 is a standard that is concerned with measurement and hence addresses three main issues: When should a provision be recognised? How should it be measured? How should it be disclosed?

We will deal with these in turn.

Provisions

Recognition of provisions

The summary of FRS 12 (Para. d) provides a succinct statement of the main issues:

A provision should be recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable that a transfer of economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met, no provision should be recognised.

A provision should only be made if a liability cannot be avoided, and this particular condition will usually be easily dealt with if there is a legal contract involved, but the standard also refers to non-legal or constructive obligations. These are obligations that arise because the reporting entity has created a valid expectation on the part of other parties that it will discharge its responsibilities towards them either because of its past actions or because it has clearly stated that it will do so (Para. 2).

If a provision is to satisfy the definition of a liability, it must have arisen from a *past event* or *obligating event*, in other words it must result from some past action of the entity such that it has 'no realistic alternative to settling the obligation created by the event' (Para. 17). The ASB strongly makes the point that financial statements deal with the entity's financial position at the end of its reporting period, and not its possible position in the future, and that no provision should be made for the costs of operating in the future or for providing against occurrences which the entity can avoid by changing its style of operations. An example of this is provided in the standard (Para. 19), namely that of an entity which might,

because of commercial pressures or legal requirements, have good evidence that it will need to incur certain expenditures if it is to operate in a particular way in the future. The example quoted is the possible need to fit a smoke filter in a certain type of factory. It is argued that this should not give rise to a provision because the entity can avoid the expenditure by changing its operating methods and, hence, there is no present liability. Intuitively, there is something a bit odd about this, for it implies that the financial statement should ignore what might potentially be a catastrophic event if, say, the likely costs of complying with new environmental requirements mean that the existing business ceases to be economically viable. The answer is that, if the potential event is high in probability and large in magnitude, its impact on the business might be reflected through the write-down of certain assets (see impairment of assets in Chapter 5) or by the removal of the assumption that the business is a going concern. These two actions are related to the future while a provision has to be firmly rooted in the past.

The decision as to whether a constructive liability exists may not be straightforward, especially if we need to identify the past or obligating event. That event might simply be the announcement of a decision. Consider the situation of a company, which, possibly because it wants to construct a plant with an ‘uncertain’ environmental impact, needs to build up the goodwill of the local community and so decides to underwrite the costs of a local arts festival. Suppose that following the announcement of the possibility of the grant the local organisers take some action resulting from that announcement which increases their financial exposure. Should the company recognise a provision even if it had not yet signed a formal agreement and could legally change its mind? If, as seems likely given the facts stated, the company believes that it must stand by the announcement, then a provision should be recognised.

The measurement of provisions

The basic rule is that:

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. (Para. 36)

Of course, but how in a world of uncertainty do we measure it? In some cases use can be made of elementary statistical techniques such as *expected values*. For example, a store might at its year end have 100 000 items still under warranty and, on the basis of experience, estimate that 5 per cent will need to be repaired, and that the average cost of repair is £300.

Then the expected value of the cost of servicing the warranty that should be recognised as a provision is:

$$(0.95 \times 0 + 0.05 \times \text{£}300) \times \text{£}100\,000 = \text{£}1\,500\,000$$

In the case of a single event a distinction needs to be drawn between the *best estimate* and the *most likely outcome*. Consider the example provided in the standard. It is of an obligation to rectify a serious fault in a plant where the ‘most likely’ outcome is that the repairs can be completely rectified at the first attempt at a cost of £1m. But this is not certain, so the provision should be for a greater amount, or ‘best estimate’, to allow for the possibility of additional expenditure. This is a variant of the expected value approach in that the additional amount would depend on both the magnitude of the cost of the additional work but also the probability that it will be necessary.

The need for prudence as conventionally defined – the asymmetric statement that profits and assets should not be overstated and expenses and liabilities not understated – is introduced in Para. 43 but the ASB goes on quickly to warn against going too far. To quote

directly, ‘if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case’ (Para. 43). This phrase, which must of one of the least elegant examples of ASB drafting, seems to exhort us to be prudent but not to overdo it.

Present values

Where the effect of the time value of money is material, the amount of the provision should be the present value of the expenditures expected to be required to settle the obligation. (Para. 45)

In the case of provisions it is recommended that the easiest way of dealing with risk is to use a discount rate that reflects the risks specific to the liability, but if this option is selected the cash flows to be discounted should not themselves be adjusted for risk; rather, the ‘best estimates’ should be used. An acceptable alternative is to adjust the cash flows for risk and use a risk-free rate of discount.

Changes in provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. (Para. 62)

Provisions and the recognition of assets

The recognition of a provision might also give rise to the recognition of an asset, but this can only be done when it is clear that the future economic benefits will flow to the entity. (Para. 66)

Disclosure requirements

The disclosure requirements are set out in Paras 89 and 90; the first paragraph deals primarily with numbers, the second mainly with words. The numerical statement should reflect the changes in provisions that have occurred during the accounting period: provisions created, used and reversed as well as increases in present values due to the passage of time and the consequences of changes in the discount rate. The words that should be supplied include, for each class of provision, the nature of the liability, some indication about the associated risk and a note of the extent of any expected reimbursements.

Contingent assets and liabilities

Company law has for a long time required the disclosure, by way of a note to the financial statements, of information concerning contingent liabilities, but there is no such requirement concerning contingent assets.

Accounting for contingencies was the subject and title of SSAP 18, issued in 1980, and this called for both the recognition, within financial statements, of certain contingent liabilities, but only in extreme cases, and the provision of note information about contingent assets but only where there was a high probability that they would unwind in the entity’s favour. FRS 12, which replaced SSAP 18, also forbids the recognition of contingent assets under any circumstances but adopts a different, less useful, definition of contingent liabilities.

Contingent assets

It will be helpful to start the discussion with the definition of a contingent asset.

A possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain events not wholly within the entity's control. (Para. 2)

A bet on a horse race would seem to satisfy the definition pretty well, so too, to take a more commercial example, would be a drug which is the subject of clinical trials. However, prudence will usually dictate that such possible assets are not accorded the status of contingent assets – which will continue to be very rare beasts.

Contingent assets: disclosure requirements

'An entity should not recognise a contingent asset' (Para. 31), but what should be disclosed? This is covered in Para. 94, which states that where 'an inflow of economic benefits is probable', the nature of the contingent assets should be disclosed with, if practicable, an estimate of their financial effect measured on the same principles as FRS 12 applies to provisions.

Contingent liabilities

The definition of a contingent liability has two elements; the first is the counterpart of the contingent asset while the second breaks new ground. A *contingent liability* is defined as:

- (a) **A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control; or**
- (b) **a present obligation that arises from past events but is not recognised because:**
 - (i) **it is not probable that a transfer of economic benefits will be required to settle the obligation; or**
 - (ii) **the amount of the obligation cannot be measured with sufficient reliability (Para. 2).**

The second part of the definition (which was not included in the SSAP 18 definition) provides a convenient vehicle for picking up items which are actually provisions, insofar that they represent *present obligations*, but which do not fully satisfy the tests for recognition set out in Para. 14, either because it is 'not probable' that the liability will have to be discharged, or because it is not possible to make a 'reliable estimate' of the liability. Thus FRS 12 requires that such pseudo-provisions should be treated in the same way as 'real' contingent liabilities. This may be convenient but it seems unfortunate that, as a result, the concept of contingency is muddled.

Figure 7.2, which is taken from FRS 12, shows a decision tree for distinguishing between provisions and contingent liabilities. The figure shows that, if it is unlikely that there is a present obligation, and that there is only a remote possibility that the liability, if it did exist, would have to be discharged, then the item can be ignored. But, if there is a reasonable chance that there is an obligation, but with very little chance that it will have to be discharged, then it should be disclosed by way of a note to the financial statements as part of contingent liabilities.

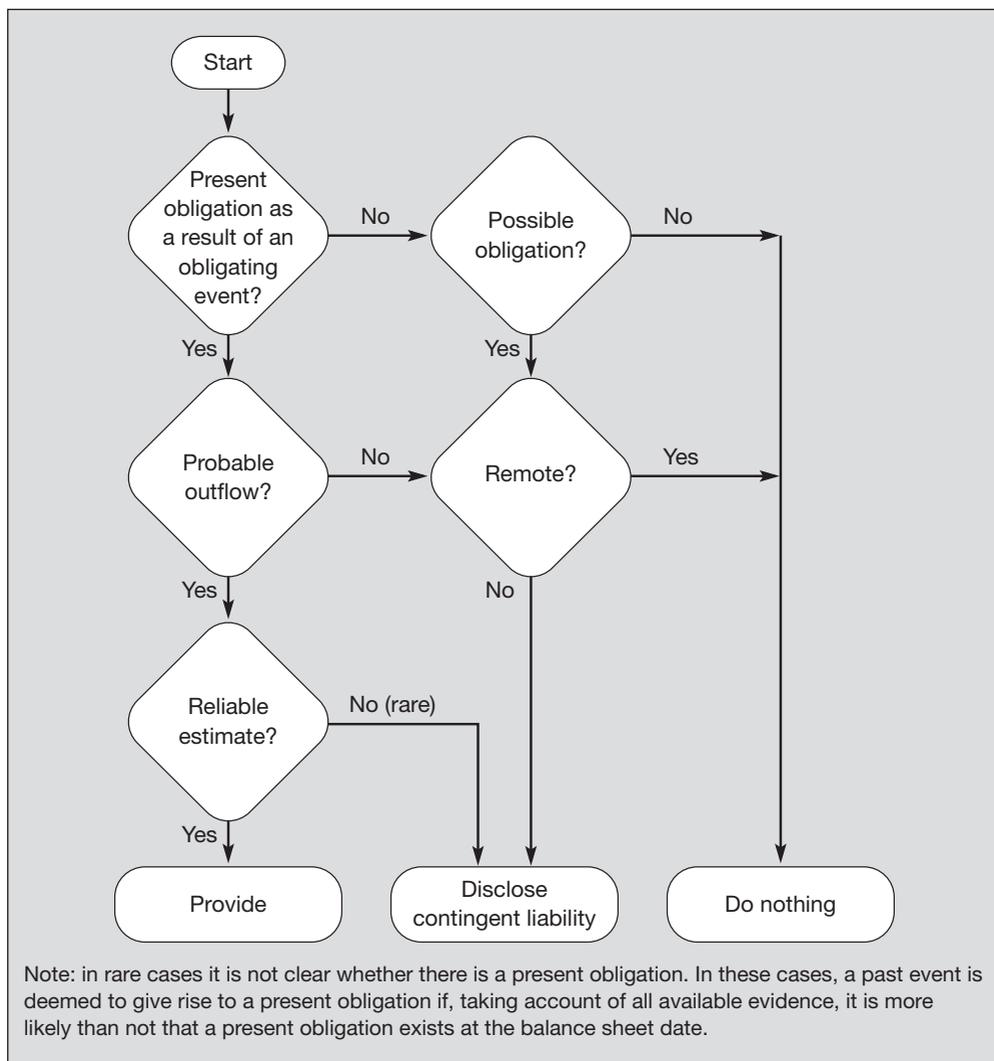


Figure 7.2 Decision tree

Source: ASB FRS 12, *Provisions, Contingent Liabilities and Assets* (1998). © ASB Publications Limited 2000. Reproduced with permission.

Contingent liabilities: disclosure requirements

As is the case with contingent assets, contingent liabilities should not be recognised but, as might be expected, the test for whether the item should be shown in the notes to the financial statements is not the same for the two items. In the case of contingent assets note disclosure is required when the inflow of benefits *is probable* while in the case of contingent liabilities disclosure can only be avoided if *the possibility of payment is remote* (Para. 91). For each class of contingent liability that passes the test information should be provided on their estimated financial effect, the uncertainties relating to the amount or timing of any outflow and an indication of the possibility of any reimbursement.

Compliance with international standards

FRS 12 was developed jointly with the international standard on the same topic, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Hence, all the requirements of the IAS are included in the FRS and there are no differences of substance between their common requirements. The FRS also deals with the circumstances under which an asset should be recognised when a provision is recognised and gives more guidance than the IAS on the discount rate to be used in the present value calculation.

Summary

In this chapter, we have introduced the subject of accounting for liabilities and have noted that this is an area where the theoretical debate is only just beginning.

We have examined the definition of a liability and explored the recognition and measurement of liabilities. We have then explored the treatment of provisions and have explained the approach of the ASB, designed particularly to stop abuses that involved the making of excessive provisions. Finally, we have discussed the nature and treatment of contingent liabilities and assets.

FRS 12 and IAS 37 were both issued in 1998 and were drafted in accordance with the same principles. Hence this is one of the relatively few areas where there is already convergence between the UK and international standards.

Recommended reading

W.T. Baxter *Accounting values and inflation*, McGraw-Hill, Maidenhead, 1975.

IATA (in association with KPMG), *Frequent flyer programme accounting*, IATA, Montreal, 1995.

'Revenue recognition' *Company Reporting* No. 142, April 2000.

P. Weetman, *Assets and liabilities: Their definition and recognition*, Certified Accountants Publications Limited, London, 1988.

Excellent up-to-date and detailed reading on the subject matter of this chapter and on much of the contents of this book is provided by the most recent edition of:

UK and International GAAP, A. Wilson, M. Davies, M. Curtis and G. Wilkinson-Riddle (eds), Ernst & Young, Butterworths Tolley, London. At the time of writing the most recent edition is the 7th, published 2001.

Questions

7.1 Provisions are particular kinds of liabilities. It therefore follows that provisions should be recognised when the definition of a liability has been met. The key requirement of a liability is a present obligation and thus this requirement is critical also in the context of the recognition of a provision. However, although accounting for provisions is an important topic for standard setters, it is only recently that guidance has been issued on provisioning in financial

statements. In the UK, the Accounting Standards Board has recently issued FRS 12 Provisions, Contingent Liabilities and Contingent Assets.

Required:

- (a) (i) Explain why there was a need for more detailed guidance on accounting for provisions in the UK. (7 marks)
- (ii) Explain the circumstances under which a provision should be recognised in the financial statements according to FRS 12: Provisions, Contingent Liabilities and Contingent Assets. (6 marks)
- (b) Discuss whether the following provisions have been accounted for correctly under FRS 12: 'Provisions, Contingent Liabilities and Contingent Assets'.

World Wide Nuclear Fuels plc disclosed the following information in its financial statements for the year ending 30 November 1999:

Provisions and long-term commitments

- (i) Provision for decommissioning the Group's radioactive facilities is made over their useful life and covers complete demolition of the facility within fifty years of it being taken out of service together with any associated waste disposal. The provision is based on future prices and is discounted using a current market rate of interest.

Provision for decommissioning costs	£m
Balance at 1.12.98	675
Adjustment arising from change in price levels charged to reserves	33
Charged in the year to profit and loss account	125
Adjustment due to change in knowledge (charged to reserves)	<u>27</u>
Balance at 30.11.99	<u>860</u>

There are still decommissioning costs of £1231m (undiscounted) to be provided for in respect of the group's radioactive facilities as the company's policy is to build up the required provision over the life of the facility

Assume that adjustments to the provision due to change in knowledge about the accuracy of the provision do not give rise to future economic benefits. (7 marks)

- (ii) The company purchased an oil company during the year. As part of the sale agreement, oil has to be supplied for a five year period to the company's former holding company at an uneconomic rate. As a result a provision for future operating losses has been set up of £135m which relates solely to the uneconomic supply of oil. Additionally the oil company is exposed to environmental liabilities arising out of its past obligations, principally in respect of remedial work to soil and ground water systems, although currently there is no legal obligation to carry out the work. Liabilities for environmental costs are provided for when the Group determines a formal plan of action on the closure of an inactive site and when expenditure on remedial work is probable and the cost can be measured with reasonable certainty. However in this case, it has been decided to provide for £120m in respect of the environmental liability on the acquisition of the oil company. World Wide Nuclear Fuels has a reputation for ensuring that the environment is preserved and protected from the effects of its business activities. (5 marks)

ACCA, Financial Reporting Environment (UK Stream), December 1999

(25 marks)

- 7.2** FRS 12 – *Provisions, contingent liabilities and contingent assets* was issued in September 1998. Prior to its publication, there was no UK Accounting Standard that dealt with the general subject of accounting for provisions.

Extract plc prepares its financial statements to 31 December each year. During the years ended 31 December 2000 and 31 December 2001, the following event occurred:

Extract plc is involved in extracting minerals in a number of different countries. The process typically involves some contamination of the site from which the minerals are extracted. Extract plc makes good this contamination only where legally required to do so by legislation passed in the relevant country.

The company has been extracting minerals in Copperland since January 1998 and expects its site to produce output until 31 December 2005. On 23 December 2000, it came to the attention of the directors of Extract plc that the government of Copperland was virtually certain to pass legislation requiring the making good of mineral extraction sites. The legislation was duly passed on 15 March 2001. The directors of Extract plc estimate that the cost of making good the site in Copperland will be £2 million. This estimate is of the actual cash expenditure that will be incurred on 31 December 2005.

Required

- (a) Explain why there was a need for an Accounting Standard dealing with provisions, and summarise the criteria that need to be satisfied before a provision is recognised. (10 marks)
- (b) Compute the effect of the estimated cost of making good the site on the financial statements of Extract plc for BOTH of the years ended 31 December 2000 and 2001. Give full explanations of the figures you compute. (10 marks)

The annual discount rate to be used in any relevant calculations is 10%. (10 marks)

CIMA, Financial Reporting – UK Accounting Standards, May 2001 (20 marks)

- 7.3** FRS 12 – *Provisions, Contingent Liabilities and Contingent Assets* requires contingencies to be classified as remote, possible, probable and virtually certain. Each of these categories should then be treated differently, depending on whether it is an asset or a liability.

Required

- (a) Explain why FRS 12 classifies contingencies in this manner. (5 marks)

The Chief Accountant of Z plc, a construction company, is finalising the work on the financial statements for the year ended 31 October 2002. She has prepared a list of all of the matters that might require some adjustment or disclosure under the requirements of FRS 12.

- (i) A customer has lodged a claim against Z plc for repairs to an office block built by the company. The roof leaks and it appears that this is due to negligence in construction. Z plc is negotiating with the customer and will probably have to pay for repairs that will cost approximately £100 000.
- (ii) The roof in (i) above was installed by a subcontractor employed by Z plc. Z plc's lawyers are confident that the company would have a strong claim to recover the whole of any costs from the subcontractor. The Chief Accountant has obtained the subcontractor's latest financial statements. The subcontractor appears to be almost insolvent with few assets.
- (iii) Whenever Z plc finishes a project, it gives customers a period of three months to notify any construction defects. These are repaired immediately. The balance sheet at 31 October 2001 carried a provision of £80 000 for future repairs. The estimated cost of repairs to completed contracts as at 31 October 2002 is £120 000.

- (iv) During the year ended 31 October 2002, Z plc lodged a claim against a large firm of electrical engineers which had delayed the completion of a contract. The engineering company's Directors have agreed in principle to pay Z plc £30 000 compensation. Z plc's Chief Accountant is confident that this amount will be received before the end of December 2002.
- (v) An architect has lodged a claim against Z plc for the loss of a laptop computer during a site visit. He alleges that the company did not take sufficient care to secure the site office and that this led to the computer being stolen while he inspected the project. He is claiming for consequential losses of £90 000 for the value of the vital files that were on the computer. Z plc's lawyers have indicated that the company might have to pay a trivial sum in compensation for the computer hardware. There is almost no likelihood that the courts would award damages for the lost files because the architect should have copied them.

Required

- (b) Explain how each of the contingencies (i) to (v) above should be accounted for. Assume that all amounts stated are material. (3 marks for each of (i) to (v) = 15 marks)

CIMA, Financial Accounting – UK Accounting Standards, November 2002 (20 marks)

7.4 L plc sells gaming cards to retailers, who then resell them to the general public. Customers who buy these cards scratch off a panel to reveal whether they have won a cash prize. There are several different ranges of cards, each of which offers a different range of prizes.

Prize-winners send their winning cards to L plc and are paid by cheque. If the prize is major, then the prize-winner is required to telephone L plc to register the claim and then send the winning card to a special address for separate handling.

All cards are printed and packaged under conditions of high security. Special printing techniques make it easy for L plc to identify forged claims and it is unusual for customers to make false claims. Large claims are, however, checked using a special chemical process that takes several days to take effect.

The directors are currently finalising their financial statements for the year ended 31 March 2002. They are unsure about how to deal with the following items:

- (i) A packaging error on a batch of 'Chance' cards meant that there were too many major prize cards in several boxes. L plc recalled the batch from retailers, but was too late to prevent many of the defective cards being sold. The company is being flooded with claims. L plc's lawyers have advised that the claims are valid and must be paid. It has proved impossible to determine the likely level of claims that will be made in respect of this error because it will take several weeks to establish the success of the recall and the number of defective cards.
- (ii) A prize-winner has registered a claim for a £200 000 prize from a 'Lotto' card. The financial statements will be finalised before the card can be processed and checked.
- (iii) A claim has been received for £100 000 from a 'Winner' card. The maximum prize offered for this game is £90 000 and so the most likely explanation is that the card has been forged. The police are investigating the claim, but this will not be resolved before the financial statements are finalised. Once the police investigation has concluded, L plc will make a final check to ensure that the card is not the result of a printing error.
- (iv) The company received claims totalling £300 000 during the year from a batch of bogus 'Happy' cards that had been forged by a retailer in Newtown. The police have prosecuted the retailer and he has recently been sent to prison. The directors of L plc have decided to pay customers who bought these cards 50% of the amount claimed as a goodwill gesture. They have not, however, informed the lucky prize-winners of this yet.

Required

- (a) Identify the appropriate accounting treatment of each of the claims against L plc in respect of (i) to (iv) above. Your answer should have due regard to the requirements of FRS 12, *Provisions, contingent liabilities and contingent assets*.
(3 marks for each of items (i) to (iv) = 12 marks)
- (b) It has been suggested that readers of financial statements do not always pay sufficient attention to contingent liabilities even though they may have serious implications for the future of the company.
- (i) Explain why insufficient attention might be paid to contingent liabilities. (4 marks)
 - (ii) Explain how FRS 12 prevents companies from treating as contingent liabilities those liabilities that should be recognised in the balance sheet. (4 marks)

CIMA, *Financial Accounting – UK Accounting Standards, May 2002*

(20 marks)