CHAPTER 13
LIABILITIES

Quick test

Question 1

All the events described in each example occur before the financial statements are authorised for issue to the shareholders, and so all fall in the period covered by events after the reporting period.

(a) The event should be classified as an *adjusting* event occurring after the end of the reporting period. Further information is now available that throws more light on the prevailing position of the receivables balance at the year end. The adjustment should be to write off the debt as an expense.

(b) This is an *adjusting* event as it related to a condition which existed at the statement of financial position date (the faulty inventory). The figure for closing inventory should be reduced from £80,000 to £60,000, which will reduce current assets on the statement of financial position and profits.

(c) This is an *adjusting* event. The receipt of the insurance claim provides additional or further evidence of conditions (negotiation of insurance claims) that existed at the statement of financial position date. A receivable for £200,000 will be shown in the statement of financial position and also credited to the statement of profit or loss.

(d) A catastrophic event such as a fire occurring after the statement of financial position date is included in the examples given in IAS 10 *Events after the Reporting Period* as a *non-adjusting* event, even though it may affect the value to the business of its assets. At the statement of financial position date the condition of the inventory was unaffected and would have been valued at the lower of cost and net realisable value; this latter figure has to be estimated as at the statement of financial position date. The chairs therefore remain valued at their cost of £45,000 in the financial statements. If the effect of the fire is considered material, a disclosure note will be made, giving details of the fire and an estimate of its financial implications.

(e) The lost warranties and repair contract do not affect the initial cost of the new machine recognised. However the company needs to consider whether the lack of maintenance cover indicates that the asset was impaired at the statement of financial position date. The value-in-use may change if the company determines that it will use the differently. In this case this would be accounted for as an *adjusting* event occurring after the end of the reporting period.

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Question 2

Provisions have to be created when it is probable that the organisation will have to transfer economic benefits. The probability is taken as more than 50% likely.

(a) *Present obligation as a result of a past obligating event:*
The obligating event is the employment contract in which the company is liable to provide health and safety for its employee.
Outflow of resources embodying economic benefits:
Probable.
Conclusion:
The directors need to create a provision for £20,000 as the employees' claim is probably going to succeed.

(b) *Present obligation as a result of a past obligating event:*
The obligating event is the provision of a hair-cut service to the customer.
Outflow of resources embodying economic benefits:
Not probable (customers claim unlikely to succeed).
Conclusion:
No provision to be made for the customer's claim.

Question 3

Legal action against Xanver plc
Present obligation as a result of a past obligating event:
Some event must have occurred before the end of the financial year, for the claim to have been made in February 20X7.
Outflow of resources embodying economic benefits:
Probable that the liability will materialise.
Conclusion
Xanver should make a provision for £200,000 (if this is the best estimate of the probable outflow).

Legal action taken by Xanver plc
Present obligation as a result of a past obligating event:
Some event must have occurred before the end of the financial year, for Xanver to have made a claim in March 20X7.
Inflow of resources embodying economic benefits:
Xanver has been advised that it is probable that it will win the case, therefore a probable asset.
Confirmation of possible asset:
This is dependent on the success of the lawsuit by Xanver (uncertain future event, not wholly within the control of the company).
Conclusion:
Xanver should disclose a contingent asset as a note for the legal action it has taken.

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Note the difference in treatment of the two probably likely cases. The legal action *against* X plc (probable outflow of resources) results in the recording of a provision; yet the legal action *by* X plc (probable inflow of resources) results in a disclosure note only.

Develop your understanding

Question 4

(a) *Present obligation as a result of a past obligating event:*
There is no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).
O*utflow of resources embodying economic benefits in settlement:*
Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.
Conclusion:
No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

(b) *Present obligation as a result of a past obligating event:*
This is a constructive obligation as Abel plc has made refunds from previous sales to customers for many years, so a valid expectation has been created that it will continue to do so. The sales are the obligating event.
Outflow of resources embodying economic benefits:
Probable as Abel plc has made the refunds for many years.
Conclusion:
A provision should be created by Abel plc at the end of its reporting period, 31 October 20X5.

(c) *Present obligation as a result of a past obligating event*:
There has been no obligating event and so there is no obligation.
Conclusion:
No provision is required.

If by 20 October 20X5 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, then the decision would change:

Present obligation as a result of a past obligating event:
The obligating event is the communication of the decision to the 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.

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Outflow of resources embodying economic benefits:
Probable
Conclusion:
A provision is recognised at 31 October 20X5 for the best estimate of the costs of closing the division.

Question 5

Present obligation as a result of a past obligating event:
There is no present obligation.
Conclusion:
No provision is recognised.

The costs of overhauling aircraft are not recognised as a provision. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the airline company's future actions – the company could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs.

Question 6

(a) This is an event after the reporting period and is an *adjusting event*. The conditions relating to the payment of the bonus existed at the statement of financial position date; the adjustments to the profits are providing evidence of how much the bonuses should be. The bonuses will be reduced to £4,500 each in the financial statements at 31 March 20X1.

(b) The decision to discontinue the division is an event after the financial reporting period. It does not affect any conditions that existed at the statement of financial position date and is therefore a *non-adjusting event*. However, because the division is considered to be material to the financial statements Carstairs plc would need to make disclosure within the 31 March 20X3 financial statements concerning the closure of the domestic appliances division.

Question 7

A provision for warranty costs is required in Balti plc's statement of financial position:
- The obligating event is the sale of the products with a one-year warranty
- An outflow of resources is probable and it can be reliably estimated, given the previous years' data.

The provision being measured involves a large population of items, so the obligation is estimated by weighting all possible outcomes by their associated probabilities, i.e. an <u>expected value</u> is calculated:

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At 31 March 20X6

	Cost (£m)	*Probability*	*Cost x probability (£m)*
No repairs	0	0.85	0
Minor repairs	3	0.14	0.420
Major repairs	12	0.01	0.120
Total			0.540

Warranty cost provision = £540,000

At 31 March 20X7

	Cost (£m)	*Probability*	*Cost x probability (£m)*
No repairs	0	0.85	0
Minor repairs	3.5	0.14	0.490
Major repairs	13	0.01	0.130
Total			0.620

Warranty cost provision = £620,000

		£
Opening provision at 1 April 20X6		540,000
Actual costs charged against provision		480,000
		60,000
Charge to statement of profit or loss	β	560,000
Closing provision at 31 March 20X7		620,000

The warranty cost expense in the statement of profit or loss for the year ended 31 March 20X7 would be £560,000, and the provision in the statement of financial position at this date would be £620,000.

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Take it further

Question 8

(a) ***Court case***
The obligating event is the supply of beer in October 20X3, and there is a present obligation as an offer of £10,000 has been made. A provision should therefore be made. However the offer has not yet been accepted, and it is uncertain whether it will be accepted or whether the customer will pursue the case. At 31 December 20X3 the best estimate for the provision is £10,000. The company may decide to disclose brief details about the uncertainty over this amount since the outcome of this increasing cannot be considered remote.

(b) ***Hops***
This is a straightforward liability. An obligation arises from a past event and there is no significant uncertainty. The purchase and the liability should be included in Warwick Refreshments' financial statements at 31 December 20X3.

(c) ***Guarantee***
No present obligation exists as Bottlebank has both net assets and met the terms of the loan. There is a possibility that the guarantee will be called in during the next 5 years and therefore the granting of the guarantee (the obligating event) may give rise to a possible obligation. This is a contingent liability which should be disclosed in the notes to the financial statements.

(d) ***Environmental discharge***
The damage occurred as a result of an obligating event – the discharge of beer. The fine of £20,000 and rectification costs of £200,000 will already be included in the accounts. There is an obligation to make good further environmental damage. There is uncertainty concerning the amount. If it is considered more likely than not that Warwick Refreshments will have to pay more in damages, a provision should be made and a best estimate of the amount will be required. The company may take the mid-point of £120,000 as this figure. Otherwise the possibility of further damages will be treated as a contingent liability and a disclosure note included in the financial statements, which explains the possible outflow and provides a range of possible amounts.

Question 9

(a) As defined in the IASB's *Conceptual Framework*, 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. It is included in the financial statements of an entity.

A provision is a liability but where some uncertainty exists. Three criteria have to be satisfied for a provision to be recognised in the financial statements:
(i) The company has a present obligation as a result of a past event.

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(ii) It is probable that an outflow of resources embodying economic events will be required to settle the obligation – probable means that the likelihood of the outflow must be >50%.
(iii) A reliable estimate can be made of the amount of the obligation.

A contingent liability is where even more uncertainty exists, for example

- there is some doubt about whether a present obligation exists; or
- it is less than 50% probable, but there is still some possibility that an outflow of resources will be required; or
- a reliable estimate of the obligation cannot be made?

So a contingent liability is 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 it is a present obligation which is not recognised because:

- it is not probable that an outflow of resources will be required to settle the obligation; or
- the amount of the obligation cannot be measured with sufficient reliability.

A contingent liability is not recognised in the financial statements, but a disclosure note, detailing its circumstances and, if possible, the monetary implications is included.

(b) In acquiring the oil platform on 1 October 20X5, Havant Oil has a present obligation as a result of a past obligating event for the environmental costs. The outflow is virtually certain, since the seabed will suffer environmental damage from the offshore oil extraction and therefore need restoration. A reliable estimate of the obligation appears to be available.

Under IAS 37 a provision is required to be set up for the outflow of resources as soon as this becomes unavoidable. For Havant Oil this would be at the same time as the platform is acquired and brought into use. Given that the outflow will not occur for 10 years, the time value of money is significant, and so the provision is for the present value of the expected costs.

The provision is 'unwound' by charging a finance cost to the statement of profit or loss each year and increasing the provision by this amount.

Provision set up at 1 October 20X5 15m x 0.386 = £5.79m

Provision required at 30 September 20X6 15m x 0.424 = £6.36m

Finance cost charged to statement of profit or loss for y/e 30 September 20X6
6.36m – 5.79m = £0.57m

[Alternatively, finance cost = 10% x 5.79m = £0.579m]

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(c) 1 At 1 October 20X8 a provision of £10m will be required for the removal of the platform since there is a present obligation as a result of a past obligating event (the accident).
Havant has an existing provision (from (i) above) of £7.695m (15m x 0.513)
An additional provision of £2.305m (10m – 7.695m) needs to be provided during the year.

2 Havant Oil will need to make a further provision for the £50m required to clean up the oil spill. This is a present obligation with a probable outflow of economic benefits and the company can reliably estimate the amount.

3 The potential amount recovery from the insurance is a contingent asset (a possible receivable that has arisen 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) and should not be recognised. Havant Oil should disclose the potential recovery in the financial statements if the insurance proceeds are probable.

4 The claims from the fishermen are a contingent liability because it is only a possible obligation at this point and the amount cannot be reliably measured. Unless the claims can be considered remote, Havant Oil should disclose the details of the claim in the financial statements, quantifying the amount if possible.

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