QUESTION 9 – IAS 37 Provisions and Contingencies (ICAP C6 A07)

You are the Chief Financial Officer of Breeze Limited, a newly incorporated company which manufactures portable air conditioners. The company has started commercial production on September 01, 2006. While reviewing the financial statements on July 31, 2007 before presentation to the board of directors for approval, you found that the following information has not been dealt with in the financial statements:

(a) While constructing the factory building it was agreed with the Union Council of the area that any damage caused to a nearby school will be restored by the company. As a gesture of goodwill the company had also offered that a donation of Rs. 500,000 would be given to the school provided the Union Council also gives a similar grant. On the balance sheet date, it was almost certain that the Union Council would pay the grant. The damage caused by construction was restored at a cost of Rs. 650,000 in July 2007. The Union Council paid the grant of Rs. 500,000 to the school in July 2007.

(b) Within six months from the start of commercial production, the company was required to maintain an in-house workers' canteen and provide subsidized meals to its workers. The cost of construction of such canteen was Rs. 800,000; whereas cost for running the canteen was Rs. 142,000 per month. The company failed to comply with the requirement of the law.

The concerned authority took a serious note of the situation and issued a show cause notice on July18, 2007. To avoid adverse consequences the company decided to start construction of the canteen immediately. It was also decided that during the construction period, the company would reimburse the full amount of meal expenses of its workers. The construction is expected to be completed on August30, 2007.

(c) The company allows full refund if the goods sold by it are returned within two months from the date of sale. According to the best estimate, the goods return ratio is 10 percent. The returned goods can be sold in second hand market at cost which is 60% of the selling price. The accounts were appropriately adjusted on June30, 2007 based on the above estimates. The actual returns and the relevant information is summarized below:

Month of Sales	Amount of sales	Returns during the month		
		May, 07	June, 07	July, 07
	Rs. In million			
May, 07	28.00	-	0.20	2.10
June, 07	32.00	-	-	0.40

Required:

Discuss each event in the light of the relevant International Accounting Standards and suggest how these should be dealt in the financial statements for the year ended June 30, 2007. **(15)**

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Part (a)

The agreement with union council to restore damages caused by construction is a legal obligation which existed at year end. The outflow is probable and reliable estimate is available. The following journal entry is to be passed:

Date	Particulars	Dr. Rs	Cr. Rs
30.06.2007	Damage expenses (P&L)	650,000	
	Provision for damages caused		650,000

There is also constructive obligation to donate to the school. The chances of giving donation are also virtually certain. The following entry is to be passed:

Date	Particulars	Dr. Rs	Cr. Rs
30.06.2007	Donation expenses (P&L)	500,000	
	Donation payable		500,000

Part (b)

There is no need to provide for cost of construction of canteen being a capital expenditure, however, it may be disclosed as capital commitment. Further, provision in respect of related fine and penalties should be recognised if reliable estimate is available. The constructive obligation to pay for meals arose after the year end, therefore, no provision is required in this respect.

Part (c)

The excess provision for sales in the month of May 2007 is to be reversed.

Date	Particulars	Dr. Rs	Cr. Rs
30.06.2007	Provision for refund	200,000	
	P&L		200,000

Rs. 28 m x 10% = Rs. 2.8m – (Rs. 0.2m + 2.1 m) = Rs. 0.5m x 40% = Rs. 0.2m

Note: Journal entries were not required. These have been given for the understanding of the students.

Examiner Comments

The question tested students' knowledge of IAS-37 on provisions, contingent liabilities, contingent assets and its application to practical scenarios. According to the IAS a provision is required to be made if three conditions are met i.e.
(i) A present obligation exists at the date of the balance sheet.
(ii) It is probable that the outflow of economics resources will take place.
(iii) The outflow can be estimated reliably.

Although it was an open book examination the students were still unable to use the above criteria in making various decisions. Most candidates betrayed their weaknesses and arrived at incorrect conclusions. Moreover, in a large number of cases, the suggested treatment was not supported with any logical reasoning. Besides the above, the following mistakes were generally witnessed in most of the answers:

***Part (a)**:*
The donation from city council was considered a receipt and netted off against restoration costs, resulting in a net provision of Rs. 150,000. Several students gave journal entries which were not required.

Part (b)
Two types of obligations were apparent from the question i.e. the obligation to subsidize the meal and the obligation to construct the canteen. With reference to the subsidized meal, some of the examinees claimed that a constructive obligation has been created on completion of six months after commencement of commercial production and hence a provision should be made. Many others claimed that no obligation has been created as the same was created after the end of the year when the company decided to pay full amount and meal expenses, hence provision should not be made. Both arguments carried weight and were acknowledged as correct. However, those who did not give any reason to support their decision lost valuable marks.

As regards the construction of canteen, several students stated that construction cost should be provided. In fact, construction cost being a capital cost did not require any provision. At the most, it needed to be disclosed as a capital commitment.

Another obligation was created due to the company's non-compliance with the requirement of the law i.e. the probable penalty/fine for legal non-compliance. Most students forgot to discuss this obligation in the light of IAS-37.

Part (c)
This part was relatively better attempted as the students were generally able to analyze as under: Actual sales returns relating to sales in June 2007 cannot be ascertained at the time of authorization of the financial statement by the Board. Therefore the provision there-against shall continue to be the same i.e. based on management's estimate of 40% of 10% of 32 million. The provision against sale returns relating to May 2007 should be adjusted to a total of 0.84 million i.e. 40% of 2.1 million.

Some of the students however made the following mistakes: Ignored the fact that the returned goods can be sold for 60% of the selling price. Declared that since G.P. ratio was not available, the amount of loss on account of sales returns could not be ascertained.