QUESTION 10 – IAS 37 Provisions and Contingencies (ICAP C6 S09)

Akber Chemicals (Pvt.) Limited is engaged in the business of manufacture and sale of different type of chemicals. The following transactions have not yet been incorporated in the financial statements for the year ended June 30, 2008:

(a) On June 15, 2008, one of its tankers carrying chemicals fell into a canal, thus polluting the water. The company has never faced such a situation before. The company has neither any legal obligation to clean the canal nor does it have any published environmental policy. In a meeting held on July 26, 2008 the Board of Directors decided to clean the canal, which is estimated to cost Rs. 5.5 million.

(b) During the second week of July 2008, a significant decline in the demand for company's products was observed which also led to a decrease in net realizable value of finished goods. It was estimated that goods costing Rs. 25 million as at June 30, 2008 would only fetch Rs. 23 million.

(c) On June 21, 2008, a customer lodged a claim of Rs. 2 million with the company as a consignment dispatched on June 1, 2008 was not according to the agreed specifications. The company's inspection team found that this defect arose because of inferior quality of raw materials supplied by the vendor. On June 28, 2008, the company lodged a claim for damages of Rs. 5.0 million, with its vendor, which include reimbursement of the cost of raw materials. The company anticipates that it will have to pay compensation to its customer and would be able to recover 50% of the amount claimed from the vendor.

Required:
Discuss how Akber Chemicals (Pvt.) Limited would deal with the above situations in its financial statements for the year ended June 30, 2008. Explain your point of view with reference to the guidance contained in the International Financial Reporting Standards. **(13)**

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Part (a)

The event of polluting occurred before the year-end but the company has neither legal obligation nor constructive obligation to clean the canal. The board of directors has decided to clean the canal but this has not been communicated. However, the disclosure may be made.

Disclosure: The Company has decided to clean the canal at an estimated cost of Rs. 5.5 million which was accidently polluted by falling off company's tanker carrying chemicals into the canal.

Part (b)

The significant decline occurred after the end of reporting period. Therefore, it is a non-adjusting event. The disclosure should be made (assuming it material):

Nature: Decrease in NRV of inventories due to decline in demand

Financial effect: Rs. 2 million [Rs. 25 – 23 million]

Part (c)

Provision for claim of Rs. 2 million should be recognised as there is present obligation as a result of past event (consignment dispatched before year-end), the outflow is probable (company anticipates it will have to pay the compensation) and the reliable estimate is available.

Reimbursement of anticipated amount with details should be disclosed as a contingent asset if it is probable. It cannot be recognised as receivable because it is not virtually certain that the amount will be received.

Examiner Comments

A very disappointing performance was witnessed in this question, which tested students' knowledge of IAS-37 "Provisions, Contingent Liabilities and Contingent Assets". Many candidates whose conclusions as regards the recognition or non-recognition of provision were correct, did not provide any justification to support their point of view. It should be noted that proper justification in support of the conclusion drawn is more important than the conclusion itself.

The other common mistakes were as follows:

(a) A large number of candidates incorrectly concluded that it was an adjusting event because the tanker fell into the canal before the year end. In this situation, since the company had no legal or constructive obligation at year end, no provision was required to be made. The obligation arose when the Board of Directors decided to clean the canal i.e. on July 26, 2008. Hence the provision was required to be made after year end.

(b) It was a non-adjusting event because indication of decline in NRV was observed after the year end. However, most of the students ignored this fact and concluded that the company should record the inventory at NRV. Many students who correctly concluded that it was a non-adjusting event, failed to point out that disclosure should be given in the financial statements for the year ended June 30, 2008, if the amount was material.

(c) Two issues were involved in this question i.e. the accounting treatment of claim lodged by the customer and the treatment of company's claim of damages from the supplier. Many candidates correctly concluded that full provision should be recognized for the claim lodged by the customer but failed to provide any/proper justification to support their conclusion. As regards the amount recoverable from the vendors, two types of opinions were expressed. Some students suggested that since the company is sure about the recovery, the amount may be recognized as a receivable whereas the others pleaded that the company is anticipating recovery but is not sure about it and hence the amount should not be recognized as receivable. Both the justifications were considered correct. However, those who were in favour of recognizing the amount as receivable, made the following mistakes: (i)Many of them recommended that the amount receivable should be netted off against the amount payable to customer which is not allowed under IAS-37. It must be noted that the IAS allows netting off the expenses and the reimbursable amount in the Statement of Comprehensive Income but not in the Statement of Financial Position. (ii) The majority could not specify that the amount to be recognized as receivable should be limited to Rs. 2.0 million i.e. the amount payable to the customer.