IAS 37 & IAS 10 (Final Revision checklist)

8 a) **Apply** and **discuss** the (i) recognition, (ii) derecognition and (iii) measurement of provisions, contingent liabilities and contingent assets including environmental provisions.[3]

RECOGNITION OF PROVISIONS

1. A provision is a liability of uncertain timing and amount. For a provision to be recognised the following criteria must be met: i) it must be capable of being measured reliably, ii) there must be a present obligation as a result of a past event; iii) resources embodying economic benefits would probably (more likely than not, more than 50% chance of occurrence) be needed to settle the obligation.

2. Additionally,

i) the **obligation must exist independently of the entity's future actions** *therefore the entity must not provide for repairs of owned assets (as opposed to leased assets: see below) as these are not independent of the entity's future actions because the entity is capable of selling the asset thus avoiding the repairs*; *expenditure on ongoing activities must not be included in a restructuring provision because ongoing activities are not independent of the entity's future actions*.

ii) the obligation must be present but the obligating event must be past;

iii) the entity must have no realistic alternative to settling the obligation created by the event e.g. onerous contracts (see below).

3. A provision can be **legal** or **constructive**. A provision is **legal** if it derives from a contract, statute or other means of applying the law. It is constructive if it derives from the valid expectations created by the entity's actions, established practice or specific published policies or intentions.

4. An **obligating event** gives rise to a legal or constructive obligation. It must be past. That means that at the reporting date the event (e.g. restructuring) must have happened for a valid provision to be recognised. The event happening does not necessarily mean that it has been completed. The restructuring can be going on through the reporting date unto the next reporting period and even beyond that. Nevertheless the estimated total cost should still be recognised in the financial statements. **The question then is how much?** This question is discussed under measurement.

Provision	Circumstances	Apply & Discuss recognition
Provision for **redundancy compensation** arising from a restructuring event	Uncertain timing because redundancies are subject to negotiation and consultation, sometimes protracted, and the entity is not entirely in control and therefore cannot predict when the negotiations will complete and the obligation will fall due.	Recognise a provision if management is committed to the plan and have setup a valid expectation that they will not set aside the plan or alter it to any material extent. This is indicated by: i) communicating the plan to specific individuals who are affected and the terms of the redundancy are specified in it; ii) management has set a realistic timetable that is quick and short, not allowing a significant opportunity for alterations and cancellations;

		iii) the locations and business segments affected have all been identified and the number of staff affected is known; iv) the entity has started to implement the plan, v) the nature of the expenditures expected to be incurred has been clearly specified.
Provision for warranty	A warranty is a promise by the entity to the customer to repair defects in purchased products that are caused by faults in manufacture or design. There is usually a time limit for the promise. The cost to the entity and the timing of the claim are uncertain.	A legal and constructive obligation exists because the entity has set up a valid expectation that it will discharge its duties under the contract. For that reason the entity should recognise a provision being the best estimate of the amount that will be required to settle the warranty obligation as a whole (for all the goods sold in the reporting period) when it falls due. See example under MEASUREMENT.
Dilapidations and other provisions relating to leased assets	Operating leases often contain clauses that require the lessee: i) to carry out periodic maintenance repairs ii) rectify terminal dilapidations and iii) to return property after the lease period in the existing condition before the start of the lease.	These restrictions make it difficult for the lessee to avoid the liability. As the leased property is not owned by the lessee there is a valid basis for recognising a provision as it would be independent of the entity's future actions. E.g. the lessees entity would not be able to sell the asset and thereby avoid the repair obligation.

5.

DERECOGNITION

6. When a provision is no longer required it must be reversed. IAS 37 strictly prohibits the re-designation of a provision to meet other obligations of the entity.

MEASUREMENT

7. IAS 37 requires the amount to be recognised as a provision to be the best estimate of the amount required to settle the present obligation at the end of the reporting period. This estimate is before tax.

8. According to IAS 37 **best estimate** is the amount that an entity would pay to settle the obligation at the end of the reporting period or to transfer it to another party at the reporting period.

9. **Estimates of outcome and financial effects** are determined by the management exercising judgment within the requirements of the Framework. This can be supplemented by evidence from specialists such as lawyers, surveyors and architects. Events and information after the reporting period is relevant and should be considered where material.

10. **Uncertainties** inherent in the estimates is a key issue to be evaluated and the standard suggests this can be done in various ways including using **expected value**. Expected value is a statistical computation which weights the cost of all the possible outcomes according to their probabilities.

Example of expected value calculation to estimate the cost of warranty claims
Under a warranty for all goods sold an entity covers the cost of repairing any manufacturing defects reported by customers within the first twelve months after purchase. The company forecasts that for the coming year 50 % percent of all goods sold will have no defects, 35% of all goods sold will have minor defects and 15% of all goods sold will have major defects. The entity estimates that it will cost $1 million to repair all minor defects and $4 million to repair all major defects. **Required** Compute the estimate for the cost of repairing to the entity under the **warranty**. **Cite the principle**. **Solution** **Expected value** method is used to estimate the cost of repairs in the light of uncertainty over occurrence in accordance with IAS 37. Accordingly, the expected cost of repairs is (50% x 0 + 35% x $1m + 15% x $4 = $0 + $.35m + $.6m = $.95m)

11. Where the effect of time value is material the provision should be discounted to its present value. This is unlike employee benefits where discounting to present value is required even if the obligation is settled only a day later than twelve months after the reporting date in which it is first recognized. And unlike employee benefits the discount rate is not the yield on a good quality corporate bond but is based on the **current market assessment** of the **time value of money** adjusted for the **unique risk profile** of the liability.

12. Future events that are likely to affect the measurement of the provision are to be taken into account if objective evidence exists to confirm that they will occur. Examples of future events are: technological advances that are likely to reduce the cost of the obligation e.g. decommissioning costs. These events and the expectation that they may occur only relate to long term provisions such as provisions for decommissioning costs.

13. **Gains** from expected future disposals should not be considered in arriving at the amount of the provision to be recognized.

14. **Reimbursements** from other parties against provisions e.g. insurance should be taken into account in arriving at the final provision. IAS 37 permits netting off in accordance with IAS 1 *Presentation of Financial Statements* as this reflects the substance of the transaction. Provide for an outflow that is probable – recognise an obligation before recognising a related reimbursement e.g. insurance recoveries. The right to be reimbursed is recognised only when the recovery is virtually certain.

15. **Provisions should be reviewed** at each balance sheet date i) to ensure it reflects the best estimate of the amount required to settle the obligation at

the reporting date; ii) it continues to be required, otherwise it should be reversed immediately; iii) it is used only for the intended purpose.

16. **Future operating losses** are not recognized as provision because there is no present obligation as a result of a past event.

17. Onerous contracts: a contract is onerous if the entity has **unavoidable costs under the contract that are in excess of the benefits it derives from it**. For example, the entity may have two separate leases for separate office premises but only occupies one premise. The situation comes about when the entity is under a restrictive lease (that it cannot sub-lease or give up) for an unexpired period and it takes up a lease for another premise. This means that the entity has now to pay rent under two leases but benefits only from the lease for the premise it occupies. The amount to be recognised is the lower of the **exit cost** (e.g. penalties) and the **fulfilment cost** (continuing lease payment costs).

Example of an onerous contract
While still bound under a non-cancellable franchise agreement (for another two years) to sell a particular brand an entity enters into another franchise agreement to sell an international brand instead of the existing brand. Although the entity does not derive any benefit from the existing franchise it nevertheless has an obligation to pay a lump-sum of $1m per annum to the franchiser for a period of two more years. The entity would need to make a provision for the total amount of lump-sum payments in the financial statements for the reporting period in which it enters into the new franchise. A present obligation is then created.
Case study

18. Onerous contracts derive from **executory contracts** (such as leases) which are outside the scope of IAS 37. However, the onerous provision is allowed to be recognized under IAS 37 as an exception.

19. A provision for onerous contracts can be recognised in relation to **occupied** and **unoccupied** leasehold property.

20. Occupied leasehold property provision would be necessary where the rent (charged above or at market rate) causes the entity to make a loss and the entity has no realistic prospect of recovering from the loss during the remaining period of the lease. So even though the rent may be economic relative to the market rates, nevertheless the contract can still be onerous on the entity and a provision may be required to reflect this. IAS 37 requires that impairment loss on the asset (e.g. impairment of leasehold improvement) should first be recognised before any onerous provision is recognised. Please refer to Tesco plc (2010) **Note 26 Provisions.**

21. Provision for unoccupied leasehold property would be required where two contracts are running but the entity benefits from only one of them. This situation is similar to the example of an onerous contract above. The main **measurement** issues are: i) what should be included in the provision? ii) how should amounts receivable under sub-leases be dealt with? iii) will the period be negotiated?

22. The **presentation** issues are: should the related liability and assets be netted off?

Discounting the estimated cash flows to present value

23. Most provisions will not require discounting as they are settled within twelve months of the end of the reporting period and the time value of money does not have a material effect on the amounts that would be needed to settle the obligation.

24. Long term provisions such as decommissioning and environmental provisions would need discounting to present value at the reporting date.

25. IAS 37 requires a **pre-tax discount rate** that reflects i) time value of money and ii) the risk of the liability (not the **entity's own credit risk** which is ignored for the purpose), iii) matches the maturity of the liability, iv) reflects the currency of the liability. (Please note: after tax discount rate is used because the effect of the measurement, a provision, is recognised as a before tax charge in the income statement before tax.)

26. The calculation should use either the risk-adjusted discount rate or the risk-adjusted cash flows but care should be taken to avoid double-adjusting for the same risk (in the discount rate and in the cash flows) thereby increasing the liability.

27. The risk- adjusted **discount rate** is lower than the **risk-free interest** rate because the lower rate is used to calculate a higher liability reflecting the risk of paying more. Consequently, a risk-free liability is smaller than a risky liability.

28. In contrast the rate on a loan (a **financial asset** to the lender) is higher to reflect the risk of recovering less.

What is the risk-free rate?

"Yield" to maturity rate is the rate of return anticipated on a bond if it is held until maturity date.

"Coupon" rate is the interest on a bond receivable by the bond holder between when the bond was issued and when it matures.

29. Typically a government bond "yield" rate (not the **coupon rate**) is used as the nominal, risk-free, pre-tax rate. Why is this appropriate? The use of this rate is appropriate where the amount being discounted is a single payment (e.g. environmental cleanup charges) to be settled at a point in time in the future <u>because</u> it mirrors the **extinguishment** of a government bond which has a single capital repayment at the end of its term.

30. So if an entity has an obligation to clean up the environment at an estimated cost of $30m, assuming a risk free gross yield on government bonds maturing in three years of 6% applicable to a provision to be settled in three years (from the reporting date) this gives a present value of $25.2m ($30m x $(1/(1+.06)^3)$ to be recognised at the reporting date.

31. The **deferred tax implications** are that (assuming a tax rate of 25%) a **deferred tax asset** (representing deferred tax charges) of $6.3m (25% of $25.2m) will be recognised if the criteria are met by the entity, that is if enough profits are expected to be generated in future to absorb the deferred tax charge (and save tax).

32. The **reason a deferred tax asset is recognised** is that the **tax base** (the maximum amount of tax chargeable in the year is nil because the provision is not deductible for tax until it is settled) whereas the profit or loss is charged $25.2m in the year in which the provision is recognised. Another way to look at this is that the carrying value of the liability ($25.2m) is higher than the tax base (nil until the provision is settled) hence a deferred tax asset is recognised.

What if the provision of $30m is made up of a string of cash flows arising in different periods? What would be the implication for the applicable discount rates? The table below gives an example of how the yields for different maturity can be set against cash flows arising in different periods

Matching yields to cash flows arising in different periods

Years to Maturity from reporting date		$m	Discount factor	Present value
1	3% yield on government bonds	15	0.971	14.57
2	5% yield on government bonds	10	0.907	9.07
3	6% yield on government bonds	5	0.840	4.20
		30		27.84

33. As can be seen a different present value is calculated as a result. Therefore the measurement of present value where cash flows arise in different periods should logically reflect the relevant yields to maturity. Logically because the discount rate should reflect the risk profile of the liability and the remaining period to maturity is a crucial factor in that.

34.

Calculation of risk-adjusted rate

35.

36.

Unwinding of the discount

37.

Compare the effects of nominal and real discount rates on profits

		Nominal discount rate		**Real discount rate**		
		Undiscounted cash flows	Provision	Undiscounted cash flows	Provision	
		$m	$m	$m	$m	
Year 0	200,000 x 1.05^3	231,525	186,368	200,000	186,368	
	Unwinding of discount		13,978		4,437	Finance cost
	Revision to estimates		0	10,000	9,540	Operating costs
Year 1			200,346	210,000	200,346	

	Unwinding of discount (Year 1 closing PV x interest rate)		15,026		4,770	Finance cost
	Revision to estimates			10,500	10,256	Operating costs
Year 2			215,372	220,500	215,372	
	Unwinding of discount (Year 2 closing PV x interest rate)		16,153		5,128	Finance cost
	Revision to estimates			11,025	11,025	Operating costs
Year 3			231,525	231,525	231,525	

Data	Expected cash flows	200,000	
	Inflation rate	5	5
	Discount rate	7.5	0.02381
	Period to maturity	3	3
	Discount factor (Year 0)	0.80496057	0.931842
	Discount factor (Year 1)	0.865332612	0.954029
	Discount factor (Year 2)	0.930232558	0.976744
	Discount factor (Year 3)	1	1

Discussion

38. Using the real discount rate gives a much lower finance charge each year and a much higher operating cost than is the case if the nominal rate is used. However, this does not result in a lower provision in the balance sheet as provisions have to be estimated at each reporting date to give the best estimates of the amount that would be required to settle the obligation. The above table gives a clear illustration of this. For example, when the real discount rate is used the expected cash flows are readjusted to reflect changes in prices and any other adjustments including the unwinding of the discount. It would be imprudent to do otherwise.

39. When the provision is included as a capital item as in decommissioning provision then any revisions to the provision are not taken direct to income but are treated as an adjustment to the carrying amount of the asset and depreciated prospectively over the remaining life of the asset. This reflects the fact that the carrying value of the related asset under construction would be recovered through continuing use thus justifying the capitalisation of the cost. (If the carrying value of the related asset would be recovered through sale this might justify charging the changes in the provision in the income statement).

CONTINGENT LIABILITIES

Background information

Contingent liabilities are a significant part of the entity's year end transactions due to the prevalence of risks. As part of the risk management of the entity most of the risks are adequately covered by insurance cover. IAS 37 allows the entity to recognise the insurance reimbursements against any provisions and permits netting off of income and expenses in the profit or loss, and assets and liabilities in the SOFP.

Examples:
- Public liability
- Employer's liability
- Professional indemnity

Contingent liabilities are prevalent in significant transactions such as
- Joint arrangements (joint and several liability)
- business combinations (contingent liabilities are treated as liabilities)
- disposal of a business (pending legal claim to be decided after the business is sold; may be covered by an indemnity IFRS 3)
- business restructuring (termination payments, professional fees, relocation costs, etc.)
- post retirement benefits
- long term disability benefits.

Contingent liabilities can change into provisions and the liability can be a long term liability necessitating discounting (not the projected unit credit method). The discount rate is different from that used in employment benefits calculations!

40. The following is a summary of the standard's guidance on how contingencies are treated:

Likelihood of outcome	Contingent liability	Contingent asset
Virtually certain (Say >95% probability)	Not contingent liability but a provision, recognise	Not a contingent asset, recognise
Probable (say 50% - 95% probability)	Not a contingent liability, recognise	Disclose
Possible but not probable (say 5-50% probability)	Disclose	No disclosure permitted
Remote (say, <5% probability)	Disclosure not required	No disclosure permitted

41. A contingent liability is a reliably *possible liability* arising from past events whose existence will be confirmed only on the occurrence or non-occurrence of uncertain future events not under the entity's control, or a present obligation that is not recognised because: a) it is not probable that a transfer of economic resources would be required to settle the obligation; or b) the amount cannot be measured reliably.

42. If one or more of the conditions for recognising a provision is not satisfied then a provision should not be recognised. Instead, a contingent liability should be disclosed in the notes to the financial statements. For example, where a present obligation for a past event cannot be estimated reliably the provision cannot be recognised but should be disclosed as a contingent liability in the notes.

43. Contingent liabilities arising from **Joint and Several Liability** contracts (e.g. IFRS 11 *Joint Arrangements*). The entity recognises it share of the liability and treats the rest as a contingent liability because should the others default then the entity, having joint responsibility for the whole of the liability, will become liable for the remainder.

44. Contingent liabilities arising from **guarantees** as in IAS 28 *Accounting for investments in associates*. The **loss making associate** can call on the

guarantee to pay off its debts. Until that event occurs the investor giving the guarantee discloses a contingent liability in its financial statements for the maximum amount of guarantee given.

45. **When is a guarantee recognised as a liability**? There is the anomalous situation under IAS 39 (IFRS 9) when a financial asset is transferred to another party following a sale and the entity gives a guarantee to protect the transferee (or buyer). The entity is said to have a continuing involvement to the extent of the maximum amount of the guarantee and it recognises a liability for the guarantee before an actual loss is incurred.

46. The circumstances in which a contingent liability is said to exist must be reviewed so that when it is *probable* that resources embodying future economic benefits could be required to settle the obligation and the amount of such settlement can be determined reliably then the contingent liability should be reclassified as a liability at that point and a provision should be made for the liability. If the liability is a long term liability (to be settled more than twelve months after the end of the period in which it was first recognized as a liability) it should be discounted to present value at the reporting date.

47. **Changes in contingent liabilities recognised in a business combination**: Until the liability is extinguished (settled, cancelled or expires) the acquirer measures the contingent liability recognised in a business combination at the higher of

- the amount that would be recognised under IAS 37
- the amount initially recognised less cumulative amortisation in accordance with IAS 18.

48. Minimum disclosure of the following is required:

- a brief description of the nature of the contingency
- an estimate of its financial effect
- an indication of the uncertainties relating to the timing and effect of any outflow
- the possibility of a re-imbursement

Exam Insight!
Critical thinking involves examining issues relating to contingent liabilities and considering their implications for identification, recognition, measurement, presentation and disclosure. Examples of issues relating to **recognition**: - whether the entity has discretion over the events or activities that give rise to the obligation e.g. can it alter its mode of operation to avoid the liability? For example, can the entity switch production to avoid environmental charges? If it can, then a provision would not be required to meet the cost of any obligation under the law to protect the environment. In that case where a specific **obligating event** has occurred e.g. a notice has been served by the Government requiring the entity to comply within a specified period, until such compliance is satisfied a contingent liability exists and should be noted in accordance with IAS 37. See case study below under Be exam sharp! - If the entity has no discretion then it cannot avoid the liability (it has no realistic alternative but to make a provision for settling the obligation. - When does a contingent liability become a provision?

- When do events after the reporting date affect the recognition of a contingent liability?
- When do events after the reporting date affect the recognition of a provision relating to a previously recognised contingent liability?
- How should agreed (e.g. with the insurance company) reimbursements be treated in the financial statements?

Examples of issues relating to **measurement:**
- Uncertainty over timing raises the issue of time value of money and the need to discount long term payment to present value once a possible liability becomes a probable liability
- Uncertainty over estimating the amount could imply that even though a present obligation exists because it cannot be measured reliably a provision cannot be recognised.
- Extent to which the cost is covered by insurance and other receipts and reimbursements including guarantees and indemnities.

How does the examiner approach the discussion type questions? Invariably the examiner will give you a case, probably spanning two reporting periods, (see worked example) and ask you to discuss **recognition, measurement and presentation** (**disclosures** would be inevitable in this topic). With such clarity of the issues and the principles as you would gain from reading the above, and provided you answer the questions in the **Practise and Pass** section you should be well equipped to answer the questions with confidence. See Entity A below (under Be Exam Sharp!) then refer to the **Practise and Pass** section.

Worked example (When the likelihood of an outflow of benefits becomes probable)

After a luxury cruise liner sank off the coast of Greece in January 2011 legal proceedings started to try to claim damages for negligence from the entity. The entity disputes any liability and, up to the date its financial statements for the year ended 31 March 2011 were authorised for issue by the board its legal advisers advised that it is probable that the entity will not be found liable. However, when the entity prepares its financial statements for the year ended 31 March 2012, its lawyers advised that the entity will probably be found liable.

Required

Discuss how the entity should account for the above events.

Solution

At 31 March 2011 no provision is recognised in the financial statements, only a note disclosing the nature of the possible liability is required unless the possibility of any outflow of resources is considered to be remote.

At 31 March 2012 a provision is recognised based on the best estimate of the amount required to settle the obligation because it is probable that a transfer of resources embodying economic benefits would be required in future. This means that a present obligation exists at 31 March 2012.

What if

i) What if the legal advice given prior to the date of authorising the accounts for issue was that a legal claim against the entity would succeed?
ii) What if the entity had insurance cover adequate for settling the claim?

How would the above scenarios be accounted for?

i) If by the time the accounts were authorised for issue the lawyers had advised that a claim against the entity would probably succeed, a provision should be made in the financial statements at 31 March 2011. The information confirms the existence of conditions at the balance sheet date. Therefore it is an **adjusting event** that gives rise to a present obligation that would result in the transfer of resources embodying economic benefits.

ii) IAS 37 allows the asset from the insurance claim to be recognised once the amount receivable from the insurance company has been agreed. This can be the case even if a provision is not recognised and only a note is disclosed about the possible liability. Where a provision is recognised reimbursement income can be netted against it in the profit or loss statement. IAS 1 *Presentation of Financial Statements* permits this because it reflects the substance of the transaction, the (insurance) reimbursement being for the purpose of offsetting the effect of the claim expense charged in profit or loss.

Students problems

The second problem is the writing side. Most people become accountants because they like numbers. But, the further you go in the exams the less number-crunching they become. Too many students see an answer and say 'I knew that', but didn't bother to write it down. Most have verbal constipation in the exam hall. They run out of things to say too quickly. Why? If there are six marks available then you have to write for 10 minutes. The problem is most run out in three. Students also try to over-complicate things. They look for trips and traps not there. (Extract from Fred Keer) Why?

Analysis of past questions and exam trends

Be exam sharp!

Which of the following is crucial to identifying a contingent liability?
a) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
b) It is a present obligation arising from a past event
c) It is a possible liability the outcome of which depends on the occurrence or non-occurrence of one or more uncertain future events.
d) It can be estimated reliably

A contingent liability is subject to
a) Impairment review in accordance with IAS 36
b) Discounting to present value using the yield on a good quality corporate bond
c) Regular review to determine when if the circumstances of its recognition have changed and a provision is required under IAS 37
d) Measurement at fair value

Entity A

The environment agency issues a notice to entity A to install smoke alarms in all its factories within twelve months or face prosecution and a possible fine of up to $2m. The notice was served on 1 July 2011. Entity A's financial year ends on 31 December. A estimates that it will cost $1.5m to comply with the notice and it is considering a number of options. The most attractive option so far is to adjust its plant and machinery and production methods so as to minimise the emission of smoke and reduce the risk of fire. This is estimated to cost $.5m. At the year end no entries have been made in the accounting records of A.

Required Discuss how the above events should be reported in the financial statements for the year ended 31 December 2011.

49.

CONTINGENT ASSETS

50. Possible assets that arise from past events whose existence is confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly under the entity's control.

51. For further details refer to the table above.

52. Example (of how the table can be applied to a scenario)

- the entity is in litigation,
- then it wins the case but there is an appeal against the decision,
- then the appeal is heard
- then the final outcome is a win and there is no further appeal against the decision.

ENVIRONMENTAL PROVISIONS

53. These provision deal with present obligations to clean up an environment that has been contaminated by the entity's actions. The obligation can be legal, statutory or constructive.
54.

8 b) (i) **Calculate** and (ii) **discuss restructuring provisions**.[3]

DEFINITION OF RESTRUCTURING

55. IAS 37 defines restructuring as a **structured programme of planned and controlled change** whereby management seeks to **materially** alter the **scope** and **mode** of operation (business model) of the entity. The following examples are given:

- management restructure e.g. downsizing
- relocation of business operations
- fundamental reorganization of the business and its operations e.g. automation, modernisation or globalisation of an organization
- sale or termination of a business segment

RECOGNITION OF PROVISIONS

56. Recognition of a provision requires the creation by the entity of a *valid expectation* on the part of those affected by the restructure. A valid expectation is created where there is a specific detailed plan for the restructure and the management has communicated it to those affected and has confirmed its commitment to implementing the plan. Management confirms its commitment to implementing the plan when it begins to implement the plan on a timetable that does not allow significant opportunity for material changes or cancellation to the plan.

57. A restructuring provision should include **only** the **direct expenditures** that arise from the restructuring which are those that are both:

- **necessarily** required by the restructuring and therefore incremental to it (and because of it)
- **not associated with the ongoing activities of the entity**

58. Examples of the content of a detailed plan that supports the recognition of a provision under IAS 37:

- identifies the business or segment of the business to be restructured
- identifies the locations to be affected
- the nature of the expenditure to be incurred e.g. decommissioning expenses
- details of when the plan will be implemented
- details of employees that will be affected, their location and function and the compensation package available for voluntary or compulsory redundancy

Be exam sharp!
Which of the following is crucial to the recognition of a provision for restructuring? a) A detailed plan exists b) Management has confirmed its commitment to the plan and there is no realistic alternative but to implement the plan. c) Significant redundancies are envisaged d) Staff have been informed about when the plan will be implemented.
Which of the following is not an example of a restructure or of the effects of a restructure? a) Sale of a disposal group? b) Termination payments c) Post employment benefits d) Long term disability benefits
The directors have discussed the plans for the restructure but have not communicated the details. A provision for restructure should be recognised to reflect the constructive obligation. a) True b) False
Communication of the plan for a restructure is a prerequisite for the recognition of a provision on the basis of a constructive obligation.

a) True
b) False

Case Study

The board of Denil met shortly before the end of the financial year ended on 31 December 2011 and agreed a formal restructuring plan consisting of

- closure of a factory employing 50 staff
- relocation of manufacturing operations to another country with the loss of 100 jobs
- modernisation of operations involving automation and integration involving retraining of some of the staff and the loss of others.

By the end of the year the board had held meetings and communicated its implementation plans to start early in the new financial year. There has been no agreement to the plan with the staff union representatives. However, the agreement is a matter of formality as the entity has to carry out the restructure in order to stem the losses and safeguard the long term viability of the entity.

Required
Discuss whether a restructuring provision should be recognised in the financial statements at 31 December 2011.

59.

WHAT THE STANDARD DOES NOT RECOGNISE AS A RESTRUCTURE

60. IAS 37 specifically excludes certain types of activities and the related expenditure from being classified as restructuring because they relate to the future conduct of the business and as such should be recognised independently of a restructuring (as if the restructuring did not take place.)

- Retraining of existing staff
- Marketing
- Investment in new systems and distribution networks

61. Costs that are recognised are those that directly relate to the restructuring and would not have been incurred but for the restructuring. The following table analyses expenditure types to provide further information that enables ongoing expenditure to be separated from restructuring expenditure. **Homework: please try and complete the table articulating the principles justifying your decision.**

	Direct cost of restructuring	**Associated with ongoing activities**
STAFF COSTS		
Redundancy payments (*exclusively incurred for the restructure*)		
Relocation incentive (incentive to staff for future operations: associated with ongoing operations)		Yes
Payroll costs – *exclusively incurred for the restructure* e.g.		

decommissioning site, dismantling & relocating plant		
Payroll costs – normal wage bill (ongoing operations)		
STATIONERY AND OTHER RUNNING COSTS		
Cost of new stationery with new addresses on (ongoing operations)		
Cost of telephones and office equipment.		
Cost of terminating computer contracts to make way for new ones		
PREMISES PLANT AND EQUIPMENT COSTS		
Cost of terminating the current lease	Yes	
Cost of **extra** rent incurred because of relocation arrangements	Yes	
Rent of new site		Yes
Cost of dismantling plant and equipment	Yes	Yes
Cost of transporting plant, equipment and inventory to new site (ongoing activities)		Yes
Cost of installing Plant and Equipment at new site		
Cost of training staff for new site operations		Yes
PROFESSIONAL FEES		
Cost of lawyers, architects, etc providing required advice for the restructure	Yes	
IDENTIFIABLE FUTURE OPERATING LOSSES		
Operating losses up to the date restructuring started		
Operating losses during the restructuring period		
Operating losses after the completion of the restructuring period		
GAINS FROM EXPECTED DISPOSAL OF ASSETS		
Gains from sale of asset expected to offset operating losses		

62. According to IAS 37 the fact that expenditure is incremental is not sufficient to warrant a provision for restructuring. It must **not** be associated with ongoing activities to be eligible for recognition as a provision for restructuring. For that reason relocation incentive bonus is not eligible for inclusion in a restructuring provision.

63. The income from disposal of assets is not anticipated just because it is part of a restructuring plan to improve the economic performance of the entity.

64. Even if the operation being reorganised is loss making its ongoing costs are not recognised as a restructuring provision unless they relate to an **onerous contract**.

8 c) **Apply** and **discuss** the accounting for **events after the reporting date**.[3]

Background information

The **reporting date** is the date on which the accounting period ends (also known as the **accounting reference period**). Up to 7 days are allowed either side of that date if it is more convenient for the entity. Check the relevant dates for Tesco plc and Barclays plc.

The financial statements are approved for issue some time after the reporting date. The date on which the financial statements are approved for issue is the publication date.

The financial statements can be adjusted for material events (**adjusting events**) that occur after the reporting date up to the date the financial statements are approved for issue by the board (the publication date).

An **adjustment** entails recognising by means of journal entries an **event** or **condition**.

Where the event is **non-adjusting** the fact can be disclosed in a note to the financial statements describing the event and its potential financial effects on the entity. E.g. if a court case is brought against an oil company for environmental pollution that occurred before the reporting date.

65. The following table gives a summary of the

Event after the reporting period	Adjusting	Non-adjusting
Sale of a disposal group or asset held for sale		
Information relating to an acquisition		
Employee leaving before satisfying vesting conditions of a bonus		
Employee leaving after satisfying vesting conditions of a bonus		
Revaluation of an asset such as a property that indicates the likelihood of impairment **at the reporting date.**		
Evidence received after the year end that provides **additional evidence of appropriate measurement of a liability** that existed at the reporting date.		
After date sales of inventory that provides **additional evidence of the net realisable value** at the reporting date.		
An **issue of shares** after the reporting date		
Acquisition of new businesses after the reporting date		
The loss or other decline in value of assets due to events occurring after the end of the reporting period.		
Dividends declared (payment is no longer at the discretion		

of the reporting entity) after the reporting period.		

Dividends

Background information

There are two types of dividend:

i) *Interim dividend* which is paid during the reporting period, before the annual financial statements are prepared.

ii) *Final dividend* which is paid after the shareholders have approved the financial statements.

66. *Dividends declared after the reporting period are not to be treated as liabilities in the financial statements for that period.* A **dividend is declared** when management has committed itself to paying it and no longer has discretion over its payment. For final dividends this only occurs after the dividend is approved by shareholders at a general meeting held to approve the financial statements. For interim dividends this usually occurs only when it is paid. For that reason "dividend liability" for equity shares is not a valid concept.

PROPOSED AMENDMENTS TO IAS 37 ED 2010/01 *Measurement of Liabilities*

67. In January 2010 the Board issued ED 2010/01 *Measurement of liabilities* to invite contributions towards the proposed changes to IAS 37. The driver for the revision is convergence. The specific objectives in this case are i) to align the requirements for recognition of costs of restructuring with those of the FASB's US GAAP; ii) to provide more specific requirements on the measurement of those liabilities that are within the scope of the proposed new standard.

68. Under the Board's proposals the terms "provision", "contingent liability" and "contingent asset" would be eliminated to be replaced by just one word "liabilities" in the new standard.

69. Under the ED's proposals assets that were previously described as "contingent assets" would be included instead in IAS 38 *Intangible assets.*

70. The only assets that would be within the scope of the new standard would be those that are inherently linked to liabilities such as amounts recognised as reimbursement rights. These assets would be recognised in future under the new standard unless they cannot be measured reliably. The "virtual certainty" criterion would be removed.

8d) (i) **Determine** and (ii) **report going concern** issues arising **after the reporting date**.[3]

Background information

Going concern is one of the **key assumptions** underlying the preparation of financial statements set out in the Framework. It simply means that the when financial statements are prepared for an entity it is assumed that the entity will continue in operational existence for the foreseeable future. Why is this assumption necessary? It is necessary for **measurement** purposes and to **provide information** to investors and creditors that could highlight whether or not the entity has going concern problems. Consider if at the reporting date the entity is expected to liquidate (close down) its activities as an alternative to the going concern assumption. The following items in the financial statements would be materially affected:

a) **Asset measurement** e.g. assets will not be stated at NBV but at their liquidated values. These could vary from scrap value (for assets to be abandoned) to *Held for Sale* values (lower of cost and fair value less cost to sell).

b) **Prepayments** would be charged as expenses immediately in the financial statements as there won't be a period to benefit from its deferral.

c) **Measurement of Liabilities**: provisions would crystallise into liabilities (and some, such as provision for warranties and decommissioning would be part of a disposal group as they would be directly associated with assets to be transferred). Deferred income becomes a liability to be refunded because the entity won't survive to deliver the service which will entitle it to recognize income. Deferred tax assets and liabilities cease to be relevant as they must all be released into the final reporting period's terminal financial statements.

d) **Measurement of income**: income cannot be deferred. All income accruing to assets must be recognised in full.

e) **Measurement of expenses**: deferral would not be appropriate as there is no future period to recover the expenses from.

f) **Equity:** amounts of equity would reflect the liquidation adjustments and the distribution of the residue will be in compliance with liquidation rules.

Determine going concern issues

71. Although operating losses that occur after the reporting period are not adjusting events, where the losses are so significant as to cast doubt on the validity of the going concern assumption the financial statements should be revised to reflect the situation. That means a going concern review must be carried out and if appropriate the above adjustments would be made.

Report Going concern issues

72. In this exceptional situation a non adjusting event (operating loss) would be an adjusting event (going concern adjustments). In terms of audit there would be a going concern qualification to draw attention to the suspension of the going concern qualification.

73.

74. Clarity and quality of discussion Revise the glossary from … and test your knowledge rigorously using i) objective tests; ii) fill in the blanks;	

iii) match the concept	
Key terms	
Key words - Coupon rate - Events - Onerous contracts - big bath provisions - restructuring - Unwinding of the discount	
Key phrases: it is worth memorizing these as **prepared phrases** could potentially save you time in the exams and make your answers read more professional.	
75. News digest & Developments	
Background information	
76.	