Part 4

Chapter 17
Provisions and contingencies

Question	Key issues
17.1	Pollution of environment, provision for rehabilitation costs
17.2	Guarantee for a loan
17.3	Accounting treatment of maintenance costs
17.4	Onerous contract
17.5	Provision for guarantees
17.6	Accounting treatment for the cost of repairing a tanker leaking oil and of cleaning up the environment
17.7	Accounting treatment of a provision for audit fees
17.8	The recognition and measurement of a provision for restructuring
17.9	Provision for future major inspection
17.10	Provision for decommissioning costs, conceptual justification, journal entries, disclosure
17.11	Provision for decommissioning costs: Part A: journals and disclosure Part B: journals and disclosure involving a change in estimate
17.12	Decommissioning costs
17.13	Provision for disposal of medical waste and legal claims

Question 17.1

Toxins Waste Disposal Limited is a company that handles the collection and disposal of toxic waste. The company's financial year ends on 31 December.

On 28 December 20X8 one of the company's tankers transporting a load of toxic waste turned over during a storm and spilled its load. The waste seeped into the ground on the side of the road polluting the area for several hundred meters. There was a public outcry by the local residents and concerned environmentalists that the contamination would spread to a nearby river, which was the source of the resident's water supply.

Due to immense negative publicity, Toxins Waste Disposal Limited's directors published a statement in the newspaper on 30 December 20X8 that the company would remove the contaminated soil and replace it with new soil by 15 February 20X9. On 31 December 20X8 the directors wish to create a provision for the rehabilitation costs but are unable to estimate what the rehabilitation of the contaminated area will cost. This is the first time that this particular chemical has been spilt and a detailed investigation will need to be carried out to determine the extent of the damage that has occurred. The investigation is to be carried out during early February 20X9. The publication date of the financial statements is 31 January 20X9.

Required:

Discuss how the directors of Toxins Waste Disposal Limited should account for and disclose the above situation in the financial statements for the year ended 31 December 20X8 in accordance with The Framework and IAS 37.

Question 17.2

Beta Limited has signed a guarantee for a loan owed by one of the directors of the company, to Standard Bank amounting to C250 000. The managing director, Mr. Beta is unsure of how to treat this guarantee. The company will only be liable for the loan if the director fails to make the payments as they fall due.

Required:

Discuss, in terms of International Financial Reporting Standards, how the guarantee of the director's loan should be treated and disclosed in the financial statements of Beta Limited.

Question 17.3

The accountant of Zimbali Limited is aware that roughly C1 000 000 will be paid in the 20X2 financial year in respect of maintenance costs. This expected expenditure is in accordance with the company policy of performing maintenance on the factory plant once every three years. The accountant wishes to provide for one third of this expected cost in the current year ended 31 December 20X0.

Required:

Critically analyse the above issue, explaining whether the treatment is correct or incorrect and justifying your advice with references to International Financial Reporting Standards.

Question 17.4

Unsure Limited entered into a contract to supply bricks to a new, foreign customer on 1 February 20X8. The order is for the supply of 10 million bricks per month from 1 June 20X8 to 31 March 20X9, a total of 100 million bricks. A special order was placed for these bricks as they are not standard bricks, but are to be used in the construction of a garden cottage for the Princess of Lalaland.

On 1 February 20X8, Unsure Ltd estimated that the contract would cost C10 million. Penalties for late delivery amount to C500 000 and penalties to cancel the contract amount to C2 000 000, payable immediately on late delivery or cancellation. Contract revenue is C1 500 000 per month.

Between February and June 20X8, prices of supplies increased by more than expected, and the cost of producing the first batch was C800 000. Prices continued to rise, and by 31 December 20X8, C12 000 000 had already been spent on the contract, and it was budgeted that C8 000 000 would need to be spent to complete it. Unsure Ltd is considering cancelling the contract, although they do not know how they will find C2 000 000 to pay the penalty for cancelling.

Required:

Discuss how this matter should be recognized and measured in the financial statements of Unsure Ltd for the year ended 31 December 20X8.

Question 17.5

Rich Kid Ltd sells various cheap, but expensive-looking electronic items. All goods are sold with a six-month guarantee, provided by Rich Kid Ltd. Rich Kid Ltd's suppliers are Money-Cruncher Ltd and Super-Duper Ltd. Super-Duper Ltd also offers a 6-month guarantee on all goods sold to Rich Kid Ltd, thus any returns by customers to Rich Kid Ltd will be passed on to Super-duper Ltd for fulfillment. Money-Cruncher offers no such refund policy, although it has occasionally refunded customers for returned goods.

Details of sales of the three companies for the year ended 31 December 20X8 follow. All sales are incurred evenly over the year.

Rich Kid Ltd: C500 000
Money-Cruncher Ltd: C5 000 000
Super-Duper Ltd: C7 000 000

Estimates of returns to the three companies

	Most likely	Worst ever	Best ever
Rich Kid Ltd	15%	30%	10%
Money-Cruncher Ltd	5%	15%	1%
Super-Duper Ltd	10%	18%	8%

Super-Duper Ltd thinks that sales in the last half of 20X8 were lower than usual, and that returns by customers will be low.

Required:

Discuss the recognition and measurement of the above transactions in the accounting records of each company at 31 December 20X8.

Question 17.6

BatterSea Shipping Limited is a South African shipping company that transports crude oil from Saudi Arabia to South Africa. On 28 September 20X9 one of the company's oil tankers was damaged in a violent storm off St Lucia on the KwaZulu Natal coastline (South Africa) and started leaking oil.

Management contracted a specialist repair contractor to repair the damage temporarily at sea, in order to prevent the oil from leaking further. The necessary repairs were carried out on 29 September 20X9 at a cost of C365 000, which was invoiced immediately.

The tanker was then sailed to Durban harbour, South Africa, where the cost of repairing it was assessed to be C2 750 000. Management entered into a contract on 12 October 20X9 to repair the ship at the harbour dry dock. The cost of the repairs would be financed by a loan from the bank at prime +1%.

The oil spill affected a 15 kilometre stretch of coastline and by 29 September 20X9 there had been a huge outcry from the general public, as well as environmentalists who were concerned about the damage to an area of such environmental significance. In light of this, the managing director made a public announcement on 30 September 20X9, on television and in the newspapers, of the company's intention to clean up the entire area affected by the spill.

Clean up of the environment would only commence once an expert team of environmentalists had assessed the extent of the damage and the most effective method of removing the spilt oil. On 20 October 20X9 management engaged a team to perform this assessment. The assessment will be available before 31 October 20X9.

The company's financial year end is 30 September and the financial statements are scheduled to be approved on 15 November 20X9.

Required:

Discuss how the directors of BatterSea Shipping Limited should account for and disclose:

a) the repairs at sea

b) the repairs at the dry dock, and

c) the cost of cleaning up the environment

in the financial statements for the year ended 30 September 20X9 in accordance with the Framework and IAS 37. A discussion of an expense is not required.

Question 17.7

You are the partner in charge of the audit of Granchester Limited., a company listed on the Johannesburg Securities Exchange. The financial year-end of the company is 30 September 20X1 and the directors wish to approve the financial statements for issue on 15 November 20X1.

In finalising the financial statements, the directors wish to create an accrual for audit fees of C1 200 000, of which C900 000 relates to audit work completed at 30 September 20X1 and the C300 000 relates to work done between 1 October 20X1 and 31 October 20X1. All the fees relate to the financial year ended 30 September 20X1.

Required:

Discuss, giving reasons, whether or not you agree with the directors' treatment of the provision for audit fees.

Question 17.8

Yolande Limited is a company that manufactures vehicles for export to Dubai. All parts used in the manufacture thereof are currently manufactured by Yolande Limited. It has recently been discovered, however, that the tyres currently manufactured by a branch of Yolande Limited (situated in Eshowe), cost far more than imported tyres from Ho Sin Limited (situated in Japan). The financial year-end of Yolande Limited is 30 June.

As a result, management has devised a detailed formal plan to close down the Eshowe tyre manufacturing branch of Yolande Limited and thereafter to import tyres instead. This plan was agreed to by every director before 30 June 20X3 and is to be implemented in December 20X4. There are approximately 50 factory and administrative staff at the Eshowe branch who will either be retrenched or retrained and relocated. All costs related to the discontinuance of this branch, having been thoroughly investigated by the company's financial team, are expected to be as follows:

- Annual gains expected from the cost savings in purchasing tyres from Ho Sin Limited in Japan rather than the more expensive tyres from the Eshowe branch: C400 000
- Retrenchment packages: C1 500 000;
- Cost of retraining those employees who will remain employed by and relocated within Yolande Ltd: C500 000.

The directors of Yolande Limited are concerned that, since the closing down of the Eshowe branch is to only take place in December 20X4, staff members who might hear about the plan may resign well before this time. For this reason, the directors have agreed not to announce the plan until 30 September 20X4.

The amounts are material but the plan above has not caused a 'going concern' problem.

Required:

a) State:
   - the definition of a liability; and
   - the recognition criteria

   as provided in The Framework.

b) State:
   - the recognition criteria specific to a provision for restructuring costs, and
   - the definition of 'restructuring',

   as set out in IAS 37

c) Discuss, with reference to the abovementioned definitions and recognition criteria, whether a provision for restructuring costs should be *recognised* in the financial statements at 30 June 20X3.

d) Assuming that a provision for restructuring costs is to be recognised, calculate the *amount* of the provision to be raised in Yolande Ltd's balance sheet as at 30 June 20X3. Briefly justify your answer.

Question 17.9

Flybynight Limited is a delivery company that delivers packages between Durban and Johannesburg on an overnight basis. During the past few years, the trucks have suffered a number of mechanical failures and an increasing number of accidents. In order to reduce the cost of travelling by road, the company purchased an aeroplane at a cost of C4 500 000. As a condition to its continued use, the aeroplane requires a major inspection every 10 000 flying hours. The aeroplane had flown 4 000 hours since its last major inspection on the date of purchase and has flown 273 hours since the date of purchase.

Flybynight Limited has estimated that the next major inspection is expected to cost C500 000 (based on the aeroplane's previous major inspection, which cost the seller C420 000).

The following entry has been processed:

	Debit	Credit
Major inspection (Asset)	500 000	
Provision for major inspection (Liability)		500 000

Required:

Analyze and discuss the accounting treatment of the major inspection. Your analysis should include a discussion of a liability, a provision and an asset.

Question 17.10

Leo Limited leases an industrial site close to a game reserve. The company recently obtained approval for heavy plant and machinery to operate on the site for a period of five years. The approval is in terms of a licence granted by the government. The Minister of Environmental Affairs approved the licence because the main activity of Leo Limited is the production of environmental friendly paper from recycled material.

The plant and machinery was purchased on 1 October 20X2 for C1 000 000. Installation costs of C175 480 were incurred and paid over the months of October, November and December of 20X2. The plant and machinery was in a condition necessary for it to be capable of operating in the manner intended by management on 1 January 20X3.

The plant and machinery has an estimated useful life of five years with no residual value. In terms of the licence, Leo Limited is obliged to dismantle the plant and machinery and restore the area at the end of its useful life. Future decommissioning costs are expected to be C120 000. The company uses a discount rate of 10% to calculate the present value of the decommissioning costs.

The financial accountant prepared the following schedule reflecting the unwinding of the discounted decommissioning costs:

Date	Years to decommissioning date	10% discount factor	PV
01/01/X3	5	0.621	74 520
31/12/X3	4	0.683	81 960
31/12/X4	3	0.751	90 120
31/12/X5	2	0.826	99 120
31/12/X6	1	0.909	109 080
31/12/X7	0	1.000	120 000

Required:

a) Discuss the appropriate accounting treatment for the future decommissioning costs. Your answer should refer to the accounting framework and to the relevant accounting standards.

b) Prepare all the journal entries relating to the above transactions that would have been processed in the accounting records of Leo Limited for the year ended 31 December ***20X3***.

c) Prepare the relevant extracts from the income statement of Leo Limited for the year ended 31 December 20X4 and from the balance sheet at 31 December 20X4. Notes to the financial statements (including accounting policies) are required in respect of provisions only.

Comparatives are required.

Question 17.11

Menace Limited purchased a nuclear plant, the details of which are as follows:

Cash purchase price (1 January 20X1):	C2 000 000
Depreciation straight-line to nil residual values:	10 years

The nuclear plant must be dismantled after 10 years, details of which are as follows:

Future decommissioning cost assessed on 1 January 20X1:	C3 000 000
Discount rate:	10%

Required:

a) Given the information provided above:

i) Show all journal entries for the years from 20X1 to 20X10.

ii) Disclose the 'provision for future decommissioning costs' note in Menace Limited's financial statements for all years affected in accordance with International Financial Reporting Standards.

b) Assuming that during 20X4 it was established that the expected cost of decommissioning has increased to C3 800 000:

i) Show the journal entries from 20X1 to 20X10 inclusive.

ii) Disclose the 'provision for future decommissioning costs' note in accordance with International Financial Reporting Standards for years 20X1 to 20X10 inclusive.

iii) Disclose the separately disclosable items: finance charges and depreciation as well as the change in estimate note in Menace Limited's financial statements, for years 20X1 to 20X4 inclusive, in accordance with International Financial Reporting Standards.

Question 17.12

Transkei Trading purchased a paper mill for C1 000 000. Future expected decommissioning costs of C1 800 000, discounted using a discount rate of 10% to the present value of C694 800, are recognised on the same date.

On 31 December 20X1, the value in use was C800 000 and the expected selling price was C1 200 000 (both figures exclude the decommissioning liability). Depreciation is to be provided on the straight-line method over the expected useful life of the paper mill of 10 years. The current financial year end is 31 December 20X1.

Required:

a) Assuming that the paper mill is purchased on 31 December 20X1:

i) Journalise the acquisition of the asset.

ii) Show the calculation of the impairment loss assuming that Transkei Trading will pay the decommissioning costs.

iii) Show the calculation of the impairment loss assuming that the hope is that a future buyer will pay the decommissioning costs.

b) Assuming that the paper mill is purchased on 1 January 20X1:

i) Journalise the acquisition of the asset, the depreciation of the asset, the unwinding of the discount and the impairment loss, if any.

ii) Show the calculation of the impairment loss assuming that Transkei Trading will pay the decommissioning costs.

iii) Show the calculation of the impairment loss assuming that the hope is that a future buyer will pay the decommissioning costs.

Question 17.13

Parklands Hospitals Limited is a private hospital group operating five hospitals in Karachi. The following information relates to the year ended 31 December 20X6.

Medical waste:

- In terms of environmental legislation the company is required to dispose of all medical waste generated by the hospitals in a socially responsible manner, within two weeks of generation, failing which penalties may be levied. The company has the necessary permit to dispose of medical waste by incineration on the site of their hospital in Karachi.

- In terms of their permit the company is allowed to dispose of 120 tons of medical waste per annum from 1 January to 31 December. The hospitals generate an average of 10 tons of medical waste per month evenly. On 25 November 20X6 the furnace used to incinerate medical waste malfunctioned and could not be repaired. A replacement furnace was commissioned immediately but will only be completed and installed on 31 January 20X7 at a cost of R1 500 000. A deposit of R500 000 was paid on 15 December 20X6.

- Due to the malfunction of the furnace the company has 12 tons of un-disposed medical waste on hand at 31 December 20X6. Management has obtained a quote from Waste Incinerators to dispose of the waste on hand during January 20X7 at an estimated cost of R10 000 per ton.

- On 25 January 20X7 the company received notification from the Environmental Agency that a penalty amounting to R125 000 would be levied as a result of not disposing of waste within the prescribed period at 31 December 20X6. Management has decided not to raise an objection to this penalty.

Legal claim:

- On 15 October 20X6, a visitor, Mr Downe, the Chief Executive Officer of a large company, slipped on a wet floor in the hospital foyer while on his way to visit his ill mother. As a result of his fall he sustained multiple fractures to his left leg and right arm and was immobilized for 4 months. On 1 December 20X6 Mr Downe filed a lawsuit against the hospital for negligence, claiming damages for the injuries sustained and loss of income suffered as a result of his fall.

- At the 31 December 20X6 the company's attorneys have reported that it is highly probable that Mr Downe's claim will be successful against the company. However they are uncertain how much would be awarded in damages as past rulings of this nature have been inconsistent. The directors have applied their minds to the amount of damages likely to be awarded and have decided that there is not enough information at the present to make a reasonable estimate. The attorneys will gain a better understanding of the possible amount of damages after the first court proceedings to be held on 1 March 20X7.

The following information is relevant:

- The financial statements were approved for issue on 15 February 20X7.

- Profit for the period has been correctly calculated as R2 858 500 (20X5: R2 212 000) after taking the above information into account.

Required:

a) Discuss how the cost of the un-disposed medical waste on hand at 31 December 20X6 *and* the penalty should be *recognised* and *measured* in the financial statements of Parklands Hospitals Limited for the year ended 31 December 20X6 in accordance with International Financial Reporting Standards.

b) Discuss how the legal claim should be *recognised, measured* and *disclosed* in the financial statements of Parklands Hospitals Limited for the year ended 31 December 20X6 in accordance with International Financial Reporting Standards.