Provisions

The Paper P2 examiner often features one question per exam that focuses on a single International Financial Reporting Standard (IFRS). But be warned – while these questions take their lead from a single IFRS, the examiner also brings in other issues from other IFRS.

The December 2010 exam included a share-based payment question called Margie. Before that, in the December 2009 exam, there was a question on impairment and, in June 2009, another on financial instruments.

In the last exam, the Margie question was not just about share-based payment. It also included financial instruments, fair value and simple share issues. Also, the question was highly analytical. There were few marks for regurgitation of knowledge. The bulk of the marks were reserved for analysis.

So to give you an idea of how these questions work, and to revisit a subject that has not been the subject of focus for a while, I am going to resurrect an old Paper P2 question called Satellite. It is a focus question that looks at provisions, but also has plenty of other accounting issues to consider. Of course, I have had to change the question slightly to bring it up to date.

The purpose of this article is to give you a feel as to how to tackle such questions.

Satellite
Satellite, a public limited company, has produced draft consolidated financial statements as at 30 November. The group accountant has asked your advice on several matters. These issues are set out below and have not been dealt with in the draft group financial statements:

1 Satellite has buildings under an operating lease. A requirement of the operating lease for the corporate offices is that the asset is returned in good condition. The operating lease was signed in the current year and lasts for six years. Satellite intends to refurbish the building in six years' time at a cost of $6m in order to meet the requirements of the lease. This amount includes the cost of renovating the exterior of the building and is based on current price levels. Currently, there is evidence that due to severe and exceptional weather damage the company will have to spend $1.2m in the next year on having the exterior of the building renovated. The company feels that this expenditure will reduce the refurbishment cost at the end of the lease by an equivalent amount. There is no provision for the above expenditure in the financial statements. (3 marks)

2 An 80% owned subsidiary company, Universe, has a leasehold property (historical cost \$8m, acquired at the year start). It has been modified to include a sports facility for the employees. Under the terms of the lease, the warehouse must be restored to its original state when the lease expires in 10 years' time or earlier termination. The present value of the costs of reinstatement are likely to be \$2m measured at the year start and the directors wish to provide for \$200,000 per annum for 10 years. The lease was signed and operated from the current year start and the modifications occurred immediately after. The directors estimate that the lease has a recoverable value of \$9.5m at 30 November year-end and have not provided for any of the above amounts. (9 marks)

3 Additionally, Satellite owns buildings at a carrying value of \$20m, which will require repair expenditure of approximately \$6m over the next five years. No provision has been made for this amount in the financial statements and depreciation is charged on leasehold buildings at 10% per annum and on owned buildings at 5% per annum, on the straight-line basis. (3 marks)

4 Universe has developed a database during the year to 30 November and it is included in intangible non-current assets at a cost of \$3m. The asset comprises the internal and external costs of developing the database. The cost of such intangible assets is amortised over five years and one year's amortisation has been charged. The database is used to produce a technical accounting manual, which is used by the whole group and sold to other parties. Net revenue of \$2m is expected from sales of the manual over its four-year life. It has quickly become a market leader in this field. Any costs of maintaining the database and the technical manual are written off as incurred. The technical manual requires substantial revision every four years. Therefore, Universe is considering providing for the cost of revision. (2 marks)

5 Satellite purchased a wholly owned subsidiary company, Globe, on 1 December, at the prior year start. The vendors commenced a legal action on 31 March during the current year over the amount of the purchase consideration, which was based on the performance of the subsidiary. An amount had been paid to the vendors and included in the calculation of goodwill but the vendors disputed the amount of this payment. The court made a decision on 30 November at the current year-end that requires Satellite to pay an additional \$8m to the vendors within three months. The directors do not know how to treat the additional purchase consideration and have not accounted for the item. (3 marks)

Required

(a) Discuss the recognition criteria for the recognition of a provision (IAS 37). (5 marks)

(b) Discuss how the above five issues should be dealt with in the group financial statements of Satellite. (20 marks)

(Total: 25 marks)

Possible answer

The marking guide was based on the usual one mark per idea well expressed. So the following would look good on a marker's screen.

(a)

Three

There are three recognition criteria.

Reasonably reliable estimate

It must be possible to make a reasonably reliable estimate of the outflow that will result from the obligation before a provision is permitted.

Obligation

There must be a present legal or constructive obligation at the year-end before a provision is permitted.

Transfer

There must be an expectation that economic benefit will flow out in the future as a result of the obligation.

Comment

Frankly, the IAS argues it is always possible to estimate the outflow and it is very rare for a transfer out to be avoidable. So, in practice, the accountant can focus purely on the obligation criteria.

Framework

Perhaps it should be noted how the above closely follows the focus of the framework on assets and liabilities. The framework also defines a liability in terms of present obligations.

(b)

1 Operating lease
Actually, it is irrelevant whether the above is operating or finance lease in the context of analysing related provisions. Either type of lease creates an obligation.

Present obligation
But the trick here is to spot the present obligation. Satellite does have a present obligation for the damage done during the tenure ($1.2m) but not for the damage that might be done in the future (maybe $4.8m).

Conclusion
So Satellite should provide $1.2m and should probably recognise the charge to the p/l as super-exceptional on the face of the income statement given its unusual nature.

2 Universe
First we must eye this problem form the perspective of the subsidiary. It is the subsidiary that will be putting through the double entry. Then we can look at the effect on the group.

Modification
The key term in this paragraph is 'modify'. We can see that Universe already has made the modifications and therefore has a present obligation as a result of this past obliging event.

Provision
So a provision is required for the cost of restoration. The provision is required at the point of modification. The modification occurred at the year start.

Measurement
However, the restoration will not take place until the end of the lease; so the time value of money must be considered. But we need to be careful here, as the $2m is already discounted.

Double entry
So the year start double entry is:

Dr	Non-current asset	$2m
Cr	Provision	$2m

Non-current asset
In fact, the above non-current asset entry goes on top of the initial premium:

Premium	$8m
Restoration	$2m
Initial cost	$10m

Depreciation
Then, of course, the above is depreciated over its life, which is 10 years.

Depreciation double entry
This is the same every year:

Dr	i/s	$1m
Cr	NCA	$1m

Unwinding
And, of course, quite separately the liability unwinds. The scenario does not tell us the discount rate, so I have assumed 10%.

Unwinding double entry
This snowballs every year (grows exponentially), but the first year journal would be as follows:

Dr	i/s	$0.2m
Cr	Prov ($2m)(10%)	$0.2m

Impairment test
There is even data for an impairment test. However, there is no impairment as the carrying value of the asset at the year-end ($9m) is less than the recoverable value ($9.5m).

Group effect
The above double entry will be accommodated by the sub. However, because this is a partially owned sub, the group/non-controlling interest effect will be 80%/20%.

3 Repairs
There appears to be no obligation for the repairs. Just an intent to repair sometime in the future.

Conclusion
So I suggest there can be no provision for the repairs.

Depreciation
Buildings should be depreciated over their useful lives regardless of being owned or otherwise.

4 Intangible
An intangible is recognised if it is purchased. Also, development is recognised if it is recoverable. It sounds like the external costs are the former and the internal costs are the latter.

Conclusion
So it appears to be reasonable to capitalise and depreciate the asset. However, I would advise Satellite to adjust the life down to four years, as that appears to be more realistic. Also, there is no obligation to revise. So no provision is possible.

5 Goodwill
Clearly, if Satellite had predicted the extra $8m, it would have put it in the consideration and the acquisition goodwill would have been higher.

Prior period adjustment (PPA)
But the only way to adjust last year's goodwill is via a PPA (restatement). This is only permissible if the $8m is a material error. But to me it sounds like a change in an estimate. So the $8m will simply have to be costed to the i/s.

IFRS 3
IFRS 3 supports this view, by giving a 12 months' limit on playing with goodwill after acquisition.

Conclusion
I hope the above gave you a feel for how you can think about addressing a focus question and how to address wider issues so that you can broaden your analysis.

Martin Jones is a lecturer at the London School of Business and Finance