CHAPTER 11

# Off balance sheet finance

## 11.1 Introduction

The main purpose of this chapter is to introduce the concept of 'off-balance sheet finance' which arises when accounting treatments allow companies not to recognise assets and liabilities that they control or on which they suffer the risks and enjoy the rewards. Various accounting standards have been issued to try to ensure that the statement of financial position properly reflects assets and liabilities such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 10 *Events after the Reporting Period*. Also the conceptual framework of accounting is important in how it requires the substance of transactions to be reflected when giving reliable information in financial statements.

### Objectives

By the end of this chapter, you should be able to:

- understand and explain why it is important that companies reflect as accurately as possible their assets and liabilities, and the implications if assets and liabilities are not reflected on the statement of financial position;
- understand and explain the concept of substance over form and why it is important in accounting;
- account for provisions, contingent liabilities and contingent assets under IAS 37 and explain the potential changes the IASB is considering in relation to provisions.

## 11.2 Traditional statements – conceptual changes

Accountants have traditionally followed an objective, transaction-based, book-keeping system for recording financial data and a conservative, accrual-based system for classifying into income and capital and reporting to users and financial analysts. Capital gearing was able to be calculated from the balance sheet on the assumption that it reported all of the liabilities used in the debt/equity ratio; and income gearing was able to be calculated from the income statement on the assumption that it reported all interest expense.

However, since the 1950s there has been a growth in the use of off balance sheet finance and complex capital instruments. The financial analyst can no longer assume that all liabilities are disclosed in the residual balances that appear in the traditional balance sheet and all interest expense is disclosed as such in the income statement when assessing risks and returns. Off balance sheet finance has made it impossible to use ratios to make valid inter-period or inter-firm comparisons based on the published financial statements.

## 11.3 Off balance sheet finance – its impact

Off balance sheet finance is the descriptive phrase for all financing arrangements where strict recognition of the legal aspects of the individual contract results in the exclusion of liabilities and associated assets from the statement of financial position. The impact of such transactions is to understate resources (assets) and obligations (liabilities) to the detriment of the true and fair view.[1] The analyst cannot determine the amount of capital employed or the real gearing ratio when attempting to assess risk and it could be said that the financial statements do not provide a fair view of the financial position, particularly if there are contracts for extended periods with heavy penalties for early termination.

This can happen as an innocent side-effect of the transaction-based book-keeping system. For example, when a company undertakes the long-term hire of a machine by payment of annual rentals, the rental is recorded in the income statement, but the machine, because it is not owned by the hirer, will not be shown in the hirer's statement of financial position.

If the facility to hire did not exist, the asset could still be used and a similar cash outflow pattern incurred by purchasing it with the aid of a loan. A hiring agreement, if perceived in terms of its **accounting substance** rather than its **legal form**, has the same effect as entering into a loan agreement to acquire the machine.

The true and fair view can also be compromised by deliberate design when the substance of transactions is camouflaged by relying on a strictly legal distinction. For example, loan capital arrangements were concealed from shareholders and other creditors by a legal subterfuge to which management and lenders were party.

One of the earliest measures to bring liabities into the balance sheet taken by standard setters was that relating to accounting for leases.

### 11.3.1 Substance over form

IAS 17 *Leases*[2] was the first formal imposition of the principle of accounting for substance over legal form, aiming to ensure that the legal characteristics of a financial agreement did not obscure its commercial impact. In particular, it was intended to prevent the commercial level of gearing from being concealed.

The standard's aim of getting the liability onto the statement of financial position is gradually being achieved but it has proved difficult with some companies structuring lease contracts to have leases, which are in substance finance leases, classified as operating leases. The effect has been that the asset and liability did not appear on the statement of financial position and so the debt/equity ratio was artificially lower and the return on capital employed artificially higher.

The explosive growth of additional and complex forms of financial arrangements during the 1980s focused attention on the need to increase the disclosure and awareness of such arrangements and led to substance over form being included as one of the qualities of reliable information in the *Framework for the Preparation and Presentation of Financial Statements*.

### 11.3.2 *Framework for the Preparation and Presentation of Financial Statements*

The *Framework* makes the following observations relating to the reliability characteristic:

### Reliability

To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to **represent faithfully** that which it either purports to represent or could reasonably be expected to represent.

### Faithful representation

To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in **assets**, **liabilities and equity** of the entity at the reporting date which meet the recognition criteria.

### Substance over form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they be accounted for and presented in accordance with their **substance and economic reality and not merely their legal form**.

The key points are that faithful representation requires that assets, liabilities and equity be reported in the statement of financial position in accordance with their substance. In fact, it is difficult to see how a faithful representation could be achieved if the economic reality of transactions were not reported in accordance with their commercial substance.

## 11.3.3 Accounting for substance over form

The IASB has not issued a standard on accounting for substance over form and therefore guidance must be sought from the *Framework for the Preparation and Presentation of Financial Statements* which we see from above provides that:

> a balance sheet should represent faithfully the transactions and other events that result in **assets**, **liabilities and equity**.

This means that to account for substance we need to consider the definitions of assets and liabilities as these will dictate the substance of a transaction. If a transaction or item meets the definition of an asset or liability and certain recognition criteria, it should be recognised on the statement of financial position regardless of the legal nature of the transaction or item.

The definitions of assets and liabilities[3] are as follows:

- An **asset** is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The definitions emphasise **economic benefits controlled** (assets) and **economic benefits transferable** (liabilities) – not legal ownership of, or title to, assets and possession of legal responsibilities for liabilities.

## 11.3.4 How to apply the definitions

This involves the consideration of key factors in analysing the commercial implications of an individual transaction. The key factors are:

1 **Substance** must first be identified by determining whether the transaction has given rise to new assets or liabilities for the reporting entity and whether it has changed the entity's existing assets and liabilities.
2 **Rights** or other access to benefits (i.e. possession of an asset) must be evidenced by the entity's exposure to risks inherent in the benefits, taking into account the likelihood of those risks having a commercial effect in practice.
3 **Obligations** to transfer benefits (i.e. acceptance of a liability) must be evidenced by the existence of some circumstance by which the entity is unable to avoid, legally or commercially, an outflow of benefits.
4 **Options, guarantees or conditional provisions** incorporated in a transaction should have their commercial effect assessed within the context of all the aspects and implications of the transaction in order to determine what assets and liabilities exist.

### 11.3.5 When is recognition required in the statement of financial position?

Having applied the definition to determine the existence of an asset or liability, it is then necessary to decide whether to include the asset or liability in the statement of financial position. This decision necessitates:

- sufficient evidence that a transfer of economic benefits is probable; and
- that monetary evaluation of the item is measurable with sufficient reliability.[4]

## 11.4 Illustrations of the application of substance over form

The following examples relating to consignment stocks, sale and repurchase agreements and debt factoring show how to identify the substance of a transaction. In each case it is essential in order to obtain accurate figures for the current assets – this in turn has an effect on the Current and Acid test ratios.

### 11.4.1 Inventory on consignment

#### Risks and rewards remain with the consignor

Inventory on consignment normally remains the property of the consignor until the risks and rewards have been transferred to the consignee, usually when a sale has been made by the consignee or the consignee takes legal ownership of the goods. This is illustrated by the following extract from the 2008 Annual Report of Imperial Tobacco:

> Revenue is recognized on products on consignment when these are sold by the consignee.

The 2008 Annual Report of Deere and Company refers specifically to the risks and rewards of ownership as follows:

> **Revenue Recognition**
> Sales of equipment and service parts are recorded when the sales price is determinable and the risks and rewards of ownership are transferred to independent parties based on the sales agreements in effect. In the US and most international locations, this transfer occurs primarily when goods are shipped. In Canada and some other international locations, certain goods are shipped to dealers on a consignment basis under which the risks and rewards of ownership are not transferred to the dealer. Accordingly, in these locations, sales are not recorded until a retail customer has purchased the goods.

### Risks and rewards transferred to the consignee

However, there are circumstances where, although the legal ownership is retained by the consignor, the economic risks and rewards are transferred to the consignee. It is necessary for these transactions to determine the commercial impact of the transaction.

### How is the commercial impact determined?

By consignment, we normally understand that the consignee has the right to return the goods. However, a contract might vary this right and so we need to consider rights of each party to have the inventory returned to the consignor.

### Effect of penalty provisions

The agreement may contain an absolute right of return of the inventory to the consignor, but in practice penalty provisions may effectively neutralise the right so that inventory is never returned.

EXAMPLE ● Producer P plc supplies leisure caravans to caravan dealer C Ltd on the following terms:

1 Each party has the option to have the caravans returned to the producer.
2 C Ltd pays a rental charge of 1% per month of the cost price of the caravan as consideration for exhibiting the caravan in its showrooms.
3 The eventual sale of a caravan necessitates C Ltd remitting to P plc the lower of:
   (a) the ex-factory price of the caravan when first delivered to C Ltd; or
   (b) the current ex-factory price of the caravan, less all rentals paid to date.
4 If the caravans remain unsold for six months, C Ltd must pay for each unsold caravan on the terms specified above.

To some extent, the risks and rewards of ownership are shared between both parties and the substance is not always easy to identify. However, in practice we must decide in favour of one party because it is not acceptable to show the caravans partly on each party's statement of financial position.

The factors in favour of treating the consigned goods as inventory of P plc are:

- P plc's right to demand the return of the vans;
- C Ltd's ability to return the vans to P plc;
- P plc is deriving a rental income per caravan for six months or until the time of sale, whichever occurs first.

The factors in favour of treating the goods as the inventory of C Ltd are:

- C Ltd's obligation to pay for unsold vans at the end of six months;
- the payment of a monthly rental charge: this may be considered as interest on the amount outstanding;
- C Ltd's payment need not exceed the ex-works price existing at the time of supply.

However, if C Ltd has an **unrestricted** right to return the caravans before the six months have elapsed it can, in theory, avoid the promise to pay for the caravans. Indeed, providing the ex-works cost has not increased beyond the rental (i.e. 1% per month), the company can recover the sum of the rental. However, the right might not be unrestricted, for example, disputes may develop if the exhibited caravans suffer wear and tear considered excessive by

P plc and the return is not accepted. Because the substance is not always easy to identify, a decision may be delayed in practice to observe how the terms actually operated, on the basis that what actually transpired constitutes the substance.

### 11.4.2 Sale and repurchase agreements

Sale and repurchase agreements appear in a variety of guises. The essential ingredient is that the original holder or purported vendor of the asset does not relinquish physical control: it retains access to the economic benefits and carries exposure to the commercial risks. In short, the characteristics of a normal sale are absent. Substance would deem that such a transaction should be treated as non-sale, the asset in question remaining in the statement of financial position of the purported vendor.

In deciding whether it is a sale or a finance agreement, consider which party enjoys the benefits and suffers the risk between sale and repurchase. In the simplest version of this kind of contract, this will usually be indicated by the prices at which the two transactions are arranged. If the prices are market prices current at the date of each transaction, risks and rewards of ownership rest with the buyer for the period between the two transactions. But if the later price displays any arithmetic linking with the former, this suggests a relationship of principal and interest between the two dates. Thus benefits and risk reside with the original entity-seller, who is in effect a borrower; the original entity-buyer is in effect a lender as in the following example.

EXAMPLE ● A company specialising in building domestic houses sells a proportion of its landholding to a merchant bank for £750,000 on 25 March 20X5, agreeing to repurchase the land for £940,800 on 24 March 20X7. The land remains under the control and supervision of the vendor.

Substance deems this contract to be a financing arrangement. The risks and rewards of ownership have not been transferred to the bank. Money has been borrowed on the security of the land. The bank is to receive a fixed sum of the capital of £750,000 and an additional £190,800 at the end of a two-year term. This equates in effect to compound interest at 12% per annum. The statement of financial position should retain the land as an asset, the cash inflow of £750,000 being displayed as a loan, redeemed two years later by its repayment at £750,000 plus the accrued interest of £190,800. Accounting for the substance of the transaction will result in a higher debt/equity ratio and a lower Return on Total Assets.

### 11.4.3 Debt factoring

Factoring is a means of accelerating the cash inflow by selling trade receivables to a third party, with the sales ledger administration being retained by the entity or handed over to the third party – this is purely a practical consideration, for example, the entity might have the better collection facilities.

#### How to determine whether the factoring is a sale of trade receivables or a borrowing arrangement

We need to consider whether the transaction really is a sale in substance, or merely a borrowing arrangement with collateral in the form of accounts receivable. In practice, this means identifying who bears the risk of ownership.

The main risk of ownership of trade receivables is the bad debt risk and the risk of slow payment. If these risks have been transferred to a third party the substance of the factoring arrangement is a genuine sale of accounts receivable, but if these risks are retained by the enterprise the factoring arrangement is in substance a loan arrangement. To decide on the transference of risks, the details of the agreement with the third party must be established.

If the agreement transfers the debts **without recourse** then the third party accepts the risks and will have no recourse to the enterprise in the event of non-payment by the debtor. The receipt of cash by the enterprise from the third party in this situation would be recorded to reduce the balance of receivables in the statement of financial position.

If the agreement transfers the debts **with recourse** then the third party has not accepted the risks and in the event of default by the debtor the third party will seek redress from the enterprise. The substance of this arrangement is a financing transaction and therefore any cash received by the enterprise from the third party will be recorded as a liability until the debtor pays. Only at that point do the risk and the obligation to repay the third party disappear.

The above examples of substance over form concentrate on the fair representation of assets and liabilities on the statement of financial position, i.e. if a transaction creates something that meets the definition of an asset or liability, it should be recognised. If, on the other hand, the risks and rewards of an asset are passed to another party, it should be derecognised from the statement of financial position regardless of the legal nature of the transaction.

## 11.5 Provisions – their impact on the statement of financial position

The IASC approved IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*[5] in July 1998. The key objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

The IAS sets out a useful **decision tree**, shown in Figure 11.1, for determining whether an event requires the creation of a provision, the disclosure of a contingent liability or no action.

In June 2005 the IASB issued an exposure draft, IAS 37 *Non-Financial Liabilities*, to revise IAS 37.

We will now consider IAS 37 treatment of provisions, contingent liabilities and contingent assets.

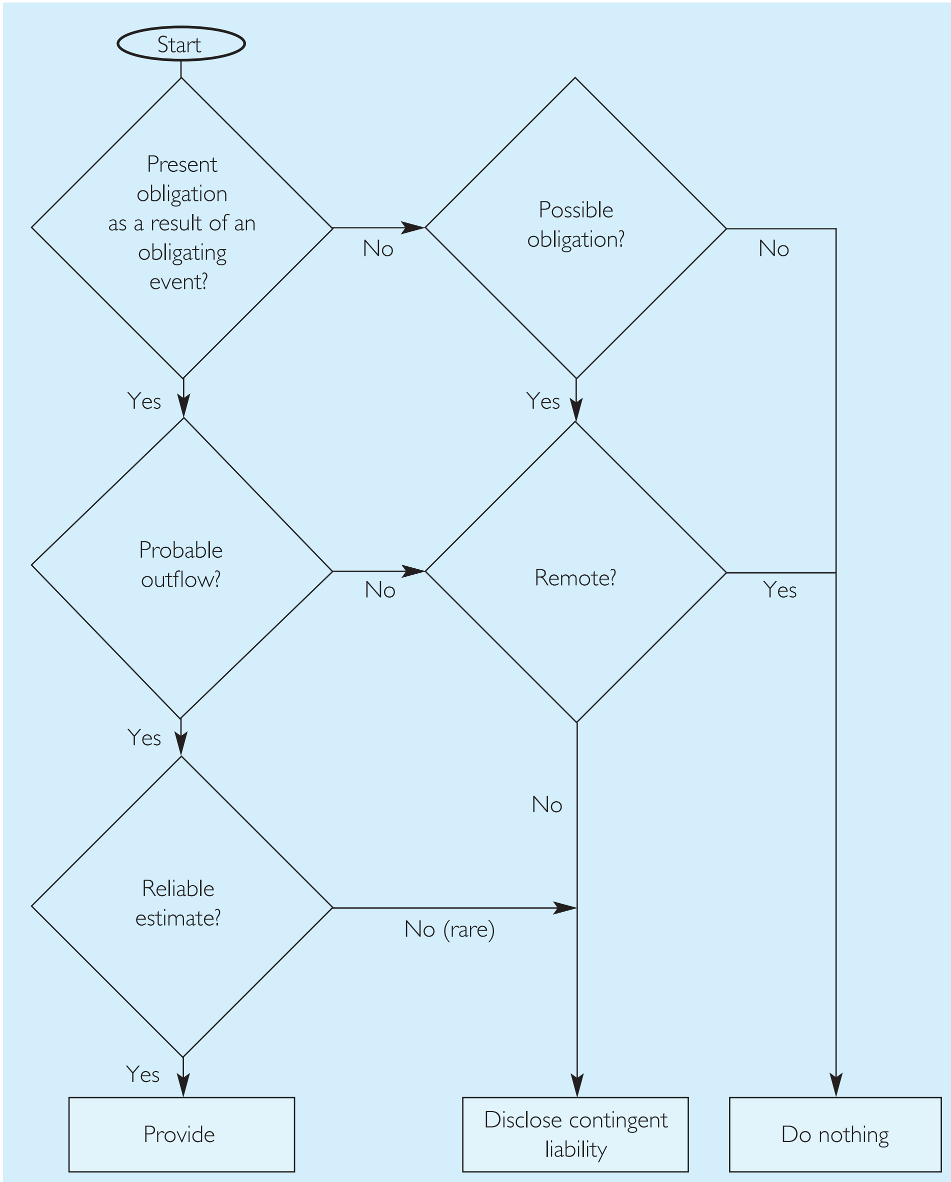
### 11.5.1 Provisions

IAS 37 is mainly concerned with provisions and the distorting effect they can have on profit trends, income and capital gearing. It defines a provision as ‘a liability of uncertain timing or amount’.

In particular it targets ‘big bath’ provisions that companies historically have been able to make. This is a type of creative accounting that it has been tempting for directors to make in order to smooth profits without any reasonable certainty that the provision would actually be required in subsequent periods. Sir David Tweedie, the chairman of the IASB, has said:

> A main focus of [IAS 37] is ‘big-bath’ provisions. Those who use them sometimes pray in aid of the concept of prudence. All too often however the provision is wildly excessive and conveniently finds its way back to the statement of comprehensive income in a later period. The misleading practice needs to be stopped and [IAS 37] proposes that in future provisions should only be allowed when the company has an unavoidable obligation – an **intention** which may or may not be fulfilled will **not be enough**. Users of accounts can’t be expected to be mind readers.

**Figure 11.1 Decision tree**




## 11.5.2 What are the general principles that IAS 37 applies to the recognition of a provision?

The general principles are that a provision should be recognised when:[6]

(a) an entity has a **present obligation** (legal or constructive) **as a result of past events**;

(b) it is **probable** that a transfer of **economic benefits will be required to settle the obligation**;

(c) **a reliable estimate** can be made of the amount of the obligation.

Provisions by their nature relate to the future. This means that there is a need for estimation and IAS 37 comments[7] that **the use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability**.

The IAS addresses the uncertainties arising in respect of present obligation, past event, probable transfer of economic benefits and reliable estimates when deciding whether to recognise a provision.

### Present obligation

The test to be applied is whether it is more likely than not, i.e. more than 50% chance of occurring. For example, if involved in a disputed lawsuit, the company is required to take account of all available evidence including that of experts and of events after the reporting period to decide if there is a greater than 50% chance that the lawsuit will be decided against the company.

Where it is more likely that no present obligation exists at the period end date, the company discloses a contingent liability, unless the possibility of a transfer of economic resources is remote.

### Past event[8]

A past event that leads to a present obligation is called an **obligating event**. This is a new term with which to become familiar. This means that the company has no realistic alternative to settling the obligation. The IAS defines no alternative as being only where the settlement of the obligation can be enforced by law or, in the case of a constructive obligation, where the event creates valid expectations in other parties that the company will discharge the obligation.

The IAS stresses that it is only those obligations arising from past events existing independently of a company's future actions that are recognised as provisions, e.g. clean-up costs for unlawful environmental damage that has occurred require a provision; environmental damage that is not unlawful but is likely to become so and involve clean-up costs will not be provided for until legislation is virtually certain to be enacted as drafted.

### Probable transfer of economic benefits[9]

The IAS defines probable as meaning that the event is more likely than not to occur. Where it is not probable, the company discloses a contingent liability unless the possibility is remote.

## 11.5.3 What are the general principles that IAS 37 applies to the measurement of a provision?

IAS 37 states[10] that the amount recognised as a provision should be the *best estimate* of the expenditure required to settle the present obligation at the period end date.

Best estimate is defined as the amount that a company would rationally pay to settle the obligation or to transfer it to a third party. The estimates of outcome and financial effect are determined by the judgement of management supplemented by experience of similar transactions and reports from independent experts. Management deal with the uncertainties as to the amount to be provided in a number of ways:

- A class obligation exists
  - where the provision involves a large population of items such as a warranty provision, statistical analysis of expected values should be used to determine the amount of the provision.

- A single obligation exists
  – where a single obligation is being measured, the individual most likely outcome may be the best estimate;
  – however, there may be other outcomes that are significantly higher or lower indicating that expected values should be determined.

For example, a company had been using unlicensed parts in the manufacture of its products and, at the year end, no decision had been reached by the court. The plaintiff was seeking damages of $10 million.

In the draft accounts a provision had been made of $5.85 million. This had been based on the entity's lawyers estimate that there was a 20% chance that the plaintiff would be unsuccessful and a 25% chance that the entity would be required to pay $10 million and a 55% chance of $7 million becoming payable to the plaintiff. The provision had been calculated as 25% of $0 + 55% of $7 million + 20% of $10 million.

The finance director disagreed with this on the grounds that it was more likely than not that there would be an outflow of funds of $7 million and required an additional $1.15 million to be provided.

Management must avoid creation of excessive provisions based on a prudent view:

- Uncertainty does not justify the creation of excessive provisions[11]
  – if the projected costs of a particular adverse outcome are estimated on a prudent basis, that outcome should not then be deliberately treated as more probable than is realistically the case.

The IAS states[12] that 'where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation'.

Present value is arrived at[13] by discounting the future obligation at 'a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.'

If provisions are recognised at present value, a company will have to account for the unwinding of the discounting. As a simple example, assume a company is making a provision at 31 December 2008 for an expected cash outflow of €1 million on 31 December 2010. The relevant discount factor is estimated at 10%. Assume the estimated cash flows do not change and the provision is still required at 31 December 2009.

| | *€000* |
|---|---|
| Provision recognised at 31 December 2008 (€1m × 1/1.121) | 826 |
| Provision recognised at 31 December 2009 (€1m × 1/1.1) | 909 |
| Increase in the provision | 83 |

This increase in the provision is purely due to discounting for one year in 2009 as opposed to two years in 2008. This increase in the provision must be recognised as an expense in profit or loss, usually as a finance cost, although IAS 37 does not make this mandatory.

The extract from the 2005/2006 Annual Report of Scottish Power highlights the unwinding of the discounting policy:

> **Mine reclamation and Closure costs**
> Provision was made for mine reclamation and closure costs when an obligation arose out of events prior to the statement of financial position date. The amount recognized was the present value of the estimated future expenditure determined in accordance with local conditions and requirements. A corresponding asset was also created of an amount

equal to the provision. This asset, together with the cost of the mine, was subsequently depreciated on a unit of production basis. The unwinding of the discount was included within finance costs.

### 11.5.4 Application of criteria illustrated

#### Scenario 1

An offshore oil exploration company is required by its licence to remove the rig and restore the seabed. Management have estimated that 85% of the eventual cost will be incurred in removing the rig and 15% through the extraction of oil. The company's practice on similar projects has been to account for the decommissioning costs using the 'unit of production' method whereby the amount required for decommissioning was built up year by year, in line with production levels, to reach the amount of the expected costs by the time production ceased.

*Decision process*

1 **Is there a present obligation as a result of a past event?**
The construction of the rig has created a legal obligation under the licence to remove the rig and restore the seabed.

2 **Is there a probable transfer of economic benefits?**
This is probable.

3 **Can the amount of the outflow be reasonably estimated?**
A best estimate can be made by management based on past experience and expert advice.

4 **Conclusion**
A provision should be created of 85% of the eventual future costs of removal and restoration.
This provision should be discounted if the effect of the time value of money is material.
A provision for the 15% relating to restoration should be created when oil production commences.

The unit of production method is not acceptable in that the decommissioning costs relate to damage already done.

#### Scenario 2

A company has a private jet costing £24 million. Air regulations required it to be overhauled every four years. An overhaul costs £1.6 million. The company policy has been to create a provision for depreciation of £2 million on a straight-line basis over twelve years and an annual provision of £400,000 to meet the cost of the required overhaul every four years.

*Decision process*

1 **Is there a present obligation as a result of a past obligating event?**
There is no present obligation. The company could avoid the cost of the overhaul by, for example, selling the aircraft.

2 **Conclusion**
No provision for cost of overhaul can be recognised. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e. an amount equivalent to the expected maintenance costs is depreciated over four years.

### 11.5.5 Disclosures

Specific disclosures,[14] for each material class of provision, should be given as to the amount recognised at the year-end and about any movements in the year, e.g.:

- **Increases in provisions** – any new provisions; any increases to existing provisions; and, where provisions are carried at present value, any change in value arising from the passage of time or from any movement in the discount rate.
- **Reductions in provisions** – any amounts utilised during the period; management are required to review provisions at each reporting date and
  - adjust to reflect the current best estimates; and
  - if it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision should be reversed.

Disclosures need not be given in cases where to do so would be seriously prejudicial to the company's interests. For example, an extract from the Technotrans 2002 Annual Report states:

> A competitor filed patent proceedings in 2000, . . . the court found in favour of the plaintiff . . . paves the way for a claim for compensation which may have to be determined in further legal proceedings . . . the particulars pursuant to IAS 37.85 are not disclosed, in accordance with IAS 37.92, in order not to undermine the company's situation substantially in the ongoing legal dispute.

- **A provision for future operating losses** should not be recognised (unless under a contractual obligation) **because there is no obligation at the reporting date**. However, where a contract becomes onerous (see next point) and cannot be avoided, then a provision should be made.

  This can be contrasted to cases where a company supplies a product as a loss leader to gain a foothold in the market. In the latter case, the company may cease production at any time. Accordingly, no provision should be recognised as no obligation exists.

A provision should be recognised if there is an onerous contract. An onerous contract is one entered into with another party under which the unavoidable costs of fulfilling the contract exceed the revenues to be received and where the entity would have to pay compensation to the other party if the contract was not fulfilled. A typical example in times of recession is the requirement to make a payment to secure the early termination of a lease where it has been imossible to sub-let the premises. This situtaion could arise where there has been a downturn in business and an entity seeks to reduce its annual lease payments on premises that are no longer required.

The nature of an onerous contract will vary with the type of business activity. For example, the following is an extract from the Kuoni Travel Holding AG 2001 Annual Report when it created a provision of over CHF80m:

> The provision for onerous contracts covers the loss anticipated in connection with excess flight capacity at Scandinavian charter airline Novair for the period up to the commencement of the 2005 summer season and resulting from the leasing agreement for an Airbus A-330. Until this time, the aircraft will be leased, for certain periods only to other airlines at the current low rates prevailing in the market. The leasing agreement will expire in autumn 2007.

- **A provision for restructuring** should only be recognised when there is a commitment supported by:

(a) a detailed formal plan for the restructuring identifying at least:
  (i) the business or part of the business concerned;
  (ii) the principal locations affected;
  (iii) details of the approximate number of employees who will receive compensation payments;
  (iv) the expenditure that will be undertaken; and
  (v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by implementing its restructuring plans or announcing its main features to those affected by it.

- **A provision for restructuring should not be created merely on the intention to restructure**. For example, a management or board decision to restructure taken before the reporting date does not give rise to a constructive obligation at the reporting date unless the company has, before the reporting date:
  – started to implement the restructuring plan, e.g. dismantling plant or selling assets;
  – announced the main features of the plan with sufficient detail to raise the valid expectation of those affected that the restructuring will actually take place.
- **A provision for restructuring** should only include the direct expenditures arising from the restructuring which are necessarily entailed and not associated with the ongoing activities of the company. For example, the following costs which relate to the future conduct of the business are not included:
  – retraining costs; relocation costs; marketing costs; investment in new systems and distribution networks.
- **A provision for environmental liabilities** should be recognised at the time and to the extent that the entity becomes obliged, legally or constructively, to rectify environmental damage or to perform restorative work on the environment. This means that a provision should be set up only for the entity's costs to meet its *legal* obligations. It could be argued that any provision for any additional expenditure on environmental issues is a public relations decision and should be written off.
- **A provision for decommissioning costs** should be recognised to the extent that decommissioning costs relate to damage already done or goods and services already received.

### 11.5.6 The use of provisions

Only expenditures that relate to the original provision are to be set against it because to set expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

#### Illustration of accounting policy from Scottish Power 2005/06 Annual Report

**Mine reclamation and closure costs**
Provision was made for mine reclamation and closure costs when an obligation arose out of events prior to the statement of financial position date. The amount recognised was the present value of the estimated future expenditure determined in accordance with local conditions and requirements. A corresponding asset was also created of an amount equal to the provision. This asset, together with the cost of the mine, was subsequently depreciated on a unit of production basis. The unwinding of the discount was included within finance costs.

### 11.5.7 Contingent liabilities

IAS 37 deals with provisions and contingent liabilities within the same IAS because the IASB regarded all provisions as contingent as they are uncertain in timing and amount. For the purposes of the accounts, it distinguishes between provisions and contingent liabilities in that:

- Provisions are a present obligation requiring a probable transfer of economic benefits that can be reliably estimated – a provision can therefore be recognised as a liability.
- Contingent liabilities fail to satisfy these criteria, e.g. lack of a reliable estimate of the amount; not probable that there will be a transfer of economic benefits; yet to be confirmed that there is actually an obligation – a contingent liability cannot therefore be recognised in the accounts but may be disclosed by way of note to the accounts or not disclosed if an outflow of economic benefits is remote.

Where the occurrence of a contingent liability becomes sufficiently probable, it falls within the criteria for recognition as a provision as detailed above and should be accounted for accordingly and recognised as a liability in the accounts.

Where the likelihood of a contingent liability is possible, but not probable and not remote, disclosure should be made, for each class of contingent liability, where practicable, of:

**(a)** an estimate of its financial effect, taking into account the inherent risks and uncertainties and, where material, the time value of money;

**(b)** an indication of the uncertainties relating to the amount or timing of any outflow; and

**(c)** the possibility of any reimbursement.

For example, an extract from the 2003 Annual Report of Manchester United plc informs as follows:

> **Contingent liabilities**
> *Transfer fees payable*
> Under the terms of certain contracts with other football clubs in respect of player transfers, certain additional amounts would be payable by the Group if conditions as to future team selection are met. The maximum that could be payable is £12,005,000 (2002 £12,548,000).
> *Guarantee on behalf of associate*
> Manchester United PLC has undertaken to guarantee the property lease of its associate, Timecreate Limited. The lease term is 35 years with annual rentals of £400,000.

### 11.5.8 Contingent assets

A contingent asset is a possible asset that arises from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control.

Recognition as an asset is only allowed if the asset is *virtually certain*, i.e. and therefore by definition no longer contingent.

Disclosure by way of note is required if an inflow of economic benefits is *probable*. The disclosure would include a brief description of the nature of the contingent asset at the reporting date and, where practicable, an estimate of their financial effect taking into account the inherent risks and uncertainties and, where material, the time value of money.

No disclosure is required where the chance of occurrence is anything less than probable. For the purposes of IAS 37, probable is defined as more likely than not, i.e. more than a 50% chance.

## 11.6 ED IAS 37 *Non-financial Liabilities*

In June 2005, the International Accounting Standards Board (IASB) proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The new title strips IAS 37 of the words ‘Provisions’, ‘Contingent’ and ‘Assets’ and adds the term ‘Non-financial’ to create the new title IAS 37 *Non-financial Liabilities*. It is interesting to see that the new Standard has been developed around the *Framework*’s definitions of an asset and a liability.

It appears that the word ‘non-financial’ has been added to distinguish the subject from ‘financial liabilities’ which are covered by IAS 32 and IAS 39.

### 11.6.1 The ‘old’ IAS 37 Provisions, Contingent Liabilities and Contingent Assets

To understand the ‘new’ approach in ED IAS 37 (Non-financial liabilities), it is necessary first to look at the ‘old’ IAS 37. The old treatment can be represented by the following table:

| *Probability* | *Contingent liabilities* | *Contingent assets* |
|---|---|---|
| Virtually certain | Liability | Asset |
| Probable ($p > 50\%$) | Provide | Disclose |
| Possible ($p < 50\%$) | Disclose | No disclosure |
| Remote | No disclosure | No disclosure |

Note that contingent liabilities are those items where the probability is less than 50% ($p < 50\%$). Where, however, the liability is probable, i.e. the probability is $p > 50\%$, the item is classified as a provision and not a contingent liability. Normally, such a provision will be reported as the product of the value of the potential liability and its probability.

Note that the approach to contingent assets is different in that the ‘prudence’ concept is used which means that only virtually certain assets are reported as an asset. If the probability is probable, i.e. $p > 50\%$ then contingent assets are disclosed by way of a note to the accounts and if the probability is $p < 50\%$ then there is no disclosure.

#### Criticisms of the ‘old’ IAS 37

The criticisms included the following:

- The ‘old’ IAS 37 was not even-handed in its treatment of contingent assets and liabilities. In ED IAS 37 the treatment of contingent assets is similar to contingent liabilities, and provisions are merged into the treatment of contingent liabilities.
- The division between ‘probable’ and ‘possible’ was too strict/crude (at the $p = 50\%$ level) rather than being proportional. For instance, if a television manufacturer was considering the need to provide for guarantee claims (e.g. on televisions sold with a three-year warranty), then it is probable that each television sold would have a less than 50% chance of being subject to a warranty claim and so no provision would need to be made. However, if the company sold 10,000 televisions, it is almost certain that there would be some claims which would indicate that a provison should be made. A company could validly take either treatment, but the effect on the financial statements would be different.
- If there was a single possible legal claim, then the company could decide it was ‘possible’ and just disclose it in the financial statements. However, a more reasonable treatment would be to assess the claim as the product of the amount likely to be paid and its probability. This latter treatment is used in the new ED IAS 37.

## 11.6.2 Approach taken by ED IAS 37 *Non-financial Liabilities*

The new proposed standard uses the term 'non-financial liabilities' which it defines as 'a liability other than a financial liability as defined in IAS32 *Financial Instruments: Presentation*'. In considering ED IAS 37, we will look at the proposed treatment of contingent liabilities/provisions and contingent assets, starting from the *Framework's* definitions of a liability and an asset.

### The *Framework*'s definition

The *Framework*, para. 91, requires a liability to be recognised as follows:

> A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

### ED IAS 37 approach to provisions

Considering a provision first, old IAS 37 (para. 10) defines it as follows:

> A provision is distinguished from other liabilities because there is uncertainty about the timing or amount of the future expenditure required in settlement.

ED IAS 37 argues that a provision should be reported as a liability, as it satisfies the *Framework*'s definition of a liability. It makes the point that there is no reference in the *Framework* to 'uncertainty about the timing or amount of the future expenditure required in settlement'. It considers a provision to be just one form of liability which should be treated as a liability in the financial statements.

### Will the item 'provision' no longer appear in financial statements?

One would expect that to be the result of the ED classification. However, the proposed standard does not take the step of prohibiting the use of the term as seen in the following extract (para. 9):

> In some jurisdictions, some classes of liabilities are described as provisions, for example those liabilities that can be measured only by using a substantial degree of estimation. Although this [draft] Standard does not use the term 'provision', it does not prescribe how entities should describe their non-financial liabilities. Therefore, entities may describe some classes of non-financial liabilities as provisions in their financial statements.

### ED IAS 37 approach to contingent liabilities

Now considering contingent liabilities, old IAS 37 (para. 10) defines these as:

**(a)** a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

**(b)** a present obligation that arises from past events, but is not recognised because:
   (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
   (ii) the amount of the obligation cannot be measured with sufficient reliability.

This definition means that the old IAS 37 has taken the strict approach of using the term 'possible' ($p < 50\%$) when it required no liability to be recognised.

ED IAS 37 is different in that it takes a two-stage approach in considering whether 'contingent liabilities' are 'liabilities'. To illustrate this, we will take the example of a restaurant where some customers have suffered food poisoning.

*First determine whether there is a present obligation*

The restaurant's year end is 30 June 20X6. If the food poisoning took place after 30 June 20X6, then this is not a 'present obligation' at the year end, so it is not a liability. If the food poisoning occurred up to 30 June, then it is a 'present obligation' at the year end, as there are possible future costs arising from the food poisoning. This is the first stage in considering whether the liability exists.

*Then determine whether a liability exists*

The second stage is to consider whether a 'liability' exists. The *Framework*'s definition of a liability says it is a liability if 'it is probable that an outflow of resources will result from the settlement of the present obligation'. So, there is a need to consider whether any payments (or other expenses) will be incurred as a result of the food poisoning. This may involve settling legal claims, other compensation or giving 'free' meals. The estimated cost of these items will be the liability (and expense) included in the financial statements.

## The rationale

ED IAS 37 explains this process as:

- the unconditional obligation (stage 1) establishes the liability; and
- the conditional obligation (stage 2) affects the amount that will be required to settle the liability.

The liability being the amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party on the statement of financial position date. Often, the liability will be estimated as the product of the maximum liability and the probability of it occurring, or a decision tree will be used with a number of possible outcomes (costs) and their probability.

In many cases, the new ED IAS 37 will cover the 'possible' category for contingent liabilities and include the item as a liability (rather than as a note to the financial statements). This gives a more 'proportional' result than the previously strict line between 'probable' ($p > 50\%$) (when a liability is included in the financial statements) and 'possible' ($p < 50\%$) (when only a note is included in the financial statements and no charge is included for the liability).

## What if they cannot be measured reliably?

For other 'possible' contingent liabilities, which have not been recognised because they cannot be measured reliably, the following disclosure should be made:

- a description of the nature of the obligation;
- an explanation of why it cannot be measured reliably;
- an indication of the uncertainties relating to the amount or timing of any outflow of economic benefits; and
- the existence of any rights to reimbursement.

### What disclosure is required for maximum potential liability?

ED IAS 37 does not require disclosure of the maximum potential liability, e.g. the maximum damages if the entity loses the legal case.

## 11.6.3 Measured reliably

The *Framework* definition of a liability includes the condition 'and the amount at which the settlement will take place can be measured reliably'. This posed a problem when drafting ED IAS 37 because of the concern that an entity could argue that the amount of a contingent liability could not be measured reliably and that there was therefore no need to include it as a liability in the financial statements – i.e. to use this as a 'cop out' to give a 'rosier' picture in the financial statements. Whilst acknowledging that in many cases a non-financial liability cannot be measured exactly, it considered that it could (and should) be estimated. It then says that cases where the liability cannot be measured reliably are 'extremely rare'. We can see from this that the ED approach is that 'measured reliably' does not mean 'measured exactly' and that cases where the liability 'cannot be measured reliably' will be 'extremely rare'.

## 11.6.4 Contingent asset

The *Framework*, para. 89, requires recognition of an asset as follows:

> An Asset is recognised in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

Note that under the old IAS 37, contingent assets included items where they were 'probable' (unlike liabilities, when this was called a 'provision'). However, probable contingent assets are not included as an asset, but only included in the notes to the financial statements.

### The ED IAS 37 approach

ED IAS 37 takes a similar approach to 'contingent assets' as it does to 'provisions/contingent liabilities'. It abolishes the term 'contingent asset' and replaces it with the term 'contingency'. The term contingency refers to uncertainty about the amount of the future economic benefits embodied in an asset, rather than uncertainty about whether an asset exists.

Essentially, the treatment of contingent assets is the same as contingent liabilities. The first stage is to consider whether an asset exists and the second stage is concerned with valuing the asset (i.e. the product of the value of the asset and its probability). A major change is to move contingent assets to IAS 38 *Intangible Assets* (and not include them in IAS 37).

The treatment of 'contingent assets' under IAS 38 is now similar to that for 'contingent liabilities/provisions'. This seems more appropriate than the former 'prudent approach' used by the 'old' IAS 37.

## 11.6.5 Reimbursements

Under the 'old' IAS 37 an asset could be damaged or destroyed, when the expense would be included in profit or loss (and any future costs included as a provision). If the insurance claim relating to this loss was made after the year-end, it is likely that no asset could be included in the financial statements as compensation for the loss, as the insurance claim was 'not certain'. In reality, this did not reflect the true situation when the insurance claim would compensate for the loss, and there would be little or no net cost.

With the new rules under ED IAS 37, the treatment of contingent assets and contingent liabilities is the same, so an asset would be included in the statement of financial position as the insurance claim, which would offset the loss on damage or destruction of the asset. But, ED IAS 37 says the liability relating to the loss (e.g. the costs of repair) must be stated separately from the asset for the reimbursement (i.e. the insurance claim) – they cannot be netted off (although they will be in profit or loss).

### 11.6.6 Constructive and legal obligations

The term 'constructive obligation' is important in determining whether a liability exists. ED IAS 37 (para. 10) defines it as:

> A constructive obligation is a present obligation that arises from an entity's past actions when:
>
> **(a)** by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities, and
>
> **(b)** as a result, the entity has created a valid expectation in those parties, that they can reasonably rely on it to discharge those responsibilities.

It also defines a legal obligation as follows:

> A legal obligation is a present obligation that arises from the following:
>
> **(a)** a contract (through its explicit or implicit terms)
>
> **(b)** legislation, or
>
> **(c)** other operating law.

A contingent liability/provision is a liability only if it is either a constructive and/or a legal obligation. Thus, an entity would not normally make a provision (recognise a liability) for the potential costs of rectifying faulty products outside their guarantee period.

### 11.6.7 Present value

ED IAS 37 says that future cash flows relating to the liability should be discounted at the pre-tax discount rate. Unwinding of the discount would still need to be recognised as an interest cost.

### 11.6.8 Subsequent measurement and de-recognition

On subsequent measurement, ED IAS 37 says the carrying value of the non-financial liability should be reviewed at each reporting date. The non-financial liability should be derecognised when the obligation is settled, cancelled or expires.

### 11.6.9 Onerous contracts

If a contract becomes onerous, the entity is required to recognise a liability as the present obligation under the contract. However, if the contract becomes onerous as a result of the entity's own actions, the liability should not be recognised until it has taken the action.

### 11.6.10 Restructurings

ED IAS 37 says:

> An entity shall recognise a non-financial liability for a cost associated with a restructuring only when the definition of a liability has been satisfied.

There are situations where management has made a decision to restructure and the ED provides that in these cases 'a decision by the management of an entity to undertake a restructuring is not the requisite past event for recognition of a liability. A cost associated with a restructuring is recognised as a liability on the same basis as if that cost arose independently of the restructuring.

### 11.6.11 Other items

These include the treatment of termination costs and future operating losses where the approach is still to assess whether a liability exists. The changes to termination costs will require an amendment to IAS 19 *Employee Benefits*. In the case of termination costs, these are only recognised when a liability is incurred: e.g. the costs of closure of a factory become a liability only when the expense is incurred and redundancy costs become a liability only when employees are informed of their redundancy. In the case of future operating losses, these are not recognised as they do not relate to a past event.

Under the new ED IAS 37, the liability arises no earlier than under the 'old' IAS 37 and sometimes later.

### 11.6.12 Disclosure

ED IAS 37 requires the following disclosure of non-financial liabilities:

For each class of non-financial liability, the carrying amount of the liability at the period-end together with a description of the nature of the obligation.

For any class of non-financial liability with uncertainty about its estimation:

**(a)** a reconciliation of the carrying amounts at the beginning and end of the period showing:
   - (i) liabilities incurred;
   - (ii) liabilities derecognised;
   - (iii) changes in the discounted amount resulting from the passage of time and the effect of any change in the discount rate; and
   - (iv) other adjustments to the amount of the liability (e.g. revisions in the estimated cash flows that will be required to settle it);

**(b)** the expected timing of any resulting outflows of economic benefits;

**(c)** an indication of the uncertainties about the amount or timing of those outflows. If necessary, to provide adequate information on the major assumptions made about future events;

**(d)** the amount of any right to reimbursement, stating the amount of any asset that has been recognised

If a non-financial liability is not recognised because it cannot be measured reliably, that fact should be disclosed together with:

**(a)** a description of the nature of the obligation;

**(b)** an explanation of why it cannot be measured reliably;

**(c)** an indication of the uncertainties relating to the amount or timing of any outflow of economic benefits; and

**(d)** the existence of any right to reimbursement.

### 11.6.13 Conclusion on ED IAS 37 Non-financial Liabilities

This proposed standard makes significant changes to the subject of 'Provisions, Contingent Liabilities and Contingent Assets', which are derived from the general principles of accounting. Its good features include:

**(a)** It is conceptually sound by basing changes on the *Framework*'s definitions of an asset and a liability.

**(b)** It is more appropriate that the treatment of provisions/contingent liabilities and contingent assets should be more 'even handed'.

**(c)** It avoids the 'strict' breaks at 50% probability between 'probable' and 'possible'. It uses probability in estimating the liability down (effectively) to 0%.

**(d)** The definition of a constructive obligation has been more clearly defined.

**(e)** It overcomes the previous anomaly of not allowing reimbursements after the year-end (e.g. where there is an unsettled insurance claim at the year-end).

However, in some ways it could be argued that the proposed standard goes too far, particularly in its new terminology:

**(a)** The abolition of the term 'contingent liability' and not defining 'provision'. The new term 'non-financial liability' does not seem as meaningful as 'contingent liability'. It would seem better (more meaningful) to continue to use the term 'contingent liability' and make this encompass provisions (as it does for contingent assets).

**(b)** It would seem more appropriate to continue to include 'contingent assets' in this Standard, rather than move them to 'intangible assets', as the treatment of these items is similar to 'contingent liabilities'.

ED IAS 37 has proved to be a controversial exposure draft where there have been significant discussions surrounding the potential changes. This project is proceeding in parallel with other projects that the IASB has in development, such as leasing and revenue recognition, and the outcomes of those projects may influence the direction the IASB takes.

## 11.7 ED/2010/1 *Measurement of Liabilities in IAS 37*

This ED is a limited re-exposure of a proposed amendment to IAS 37. It deals with only one of the measurement requirements for liabilities. The ED proposes that the non-financial liability should be measured at the amount that the entity would rationally pay to be relieved of the liability.

If the liability cannot be cancelled or transferred, the liability is measured as the present value of the resources required to fulfil the obligation. It may be that the resources required are uncertain. If so, the expected value is estimated based on the probability weighted average of the outflows. The expected value is then increased to take into account the risk that the actual outcome might be higher, estimating the amount a third party would require to take over this risk.

If the liability can be cancelled or transferred, there is a choice available – to fulfil the obligation, to cancel the obligation or to transfer the liability. The logical choice is to choose the lower of the present value of fulfilling the obligation and the amount that would have to be paid to either cancel or transfer.

#### Potential impact on ratios and transparency

A new standard that applies this measurement approach will not have an identical impact on all entities – some will have to include higher non-liabilities on their statement of financial position, others will have to reduce the non-liabilities. This means that there will be different impacts on returns on equity, gearing and debt covenants.

Given the process of establishing expected values and risk adjustments, it might be that additional narrative explanation will be required in the annual report – particularly if the non-liabilities are material.

## 11.8 Special purpose entities (SPEs) – lack of transparency

Investors rely on the financial statements presenting a true and fair view of material items. Whilst an SPE might be set up for a commercially acceptable purpose such as to finance the purchase of non-current assets it can also be designed to conceal from investors the existence of material liabilities or losses or the payment of fees to directors of the sponsor company. In the case of Enron it is reported that there was concealment of all three such material items.

### 11.8.1 How does an SPE operate?

Typically there are four parties involved, namely,

- the sponsor (a company such as Enron that wishes to acquire a non-current asset but wants to keep the asset and liability off the balance sheet);
- the SPE (this is the entity that will borrow the funds to acquire the non-current asset);
- the lender (a bank or institution prepared to advance funds to the SPE to acquire the asset); and
- the independent investor (who puts in at least 3% of the cost of the asset and who technically controls the SPE).

As far as the sponsor is concerned, both the asset and the liability are off the balance sheet and the sponsor enters into a lease arrangement with the SPE to make lease payments to cover the loan repayments. If required by the lender, the sponsor might also arrange for a guarantee to be provided using its own share price strength or through another party. As we recognised in the UK prior to the introduction of FRS 5, by keeping debt off the balance sheet a company's creditworthiness is improved.

The second problem was that investors were unable to rely on advice from analysts. It is reported that analysts failed to follow sound financial analysis principles, being under pressure to hype the shares, e.g. to keep the share price up particularly where their employers, such as investment banks, were making significant advisory fees.[15]

The third problem was that investors were not alerted by the auditors to the fact that such liabilities, losses and the payment of fees existed. It could be that the auditors were convinced that the financial statements complied with the requirements of US GAAP and that the SPEs did not therefore need to be consolidated. If that were the case, it could be argued that the auditor was acting professionally in reporting that the financial statements complied with US GAAP.

## 11.9 Impact of converting to IFRS

Owing to the importance of the statement of financial position, the impact of converging to IFRS on the statement must be considered. Changes to the statement of financial position can arise from (a) corrections that result in a change in the total assets and liabilities and (b) reclassification that do not result in any increase or decrease in total assets and liabilities.

### (a) IFRS corrections

The general changes to assets and liabilities, together with an example, are shown below.

As regards liabilities, this may arise from:

- the recognition of new liabilities onto the statement of financial position, e.g. provisions for environmental and decommissioning costs; and
- the derecognition of existing liabilities, e.g. provisions for future restructuring costs that are no longer permitted to be created.

As regards assets, this may arise from:

- the recognition of new assets, e.g. derivative financial assets; and
- the derecognition of existing assets, e.g. start-up costs and research that had been currently capitalised.

### (b) IFRS reclassifications

For some companies the main impact might, however, arise from the reclassification of existing assets and liabilities. This is illustrated with the following extract from the Annual Report of Arinso International – in Figure 11.2 – which converted to IFRS in 2003 and restated its 2002 statement of financial position.

Changes might affect the perceptions of risk by different investors and can therefore potentially affect the ability of companies to raise capital and provide adequate returns to investors. It is important therefore that users have an understanding of any economic impact arising from any changes.

Investors may be interested in the effect on retained earnings and distributable profits, e.g. retained earnings have increased by €1,567,936; loan creditors may be interested in the effect on non-current liabilities where there has been a decrease to €378,724 from €1,111,803 with an impact on gearing and the possibility in some companies of improved compliance with debt covenants; and creditors may be interested in the effect on liquidity with the current ratio falling from 3.6:1 to 1.5:1.

There might be difficulties in differentiating real changes in performance from the impact of the new IFRS requirements. It will be important for companies to highlight the economic impact of any changes on their business strategy, treasury management, financing, profitability and dividends, e.g. Barclays have indicated that there will be little impact on profit after tax and earnings per share but that there will be an impact on the statement of financial position as off balance sheet items are brought on to the statement of financial position.

**Figure 11.2 Extract from Arinso 2002 restated balance sheet**

| | Belgian GAAP | IFRS |
|---|---|---|
| Non-current assets | 16,389,061 | 15,420,553 |
| Current assets | | |
| Trade receivables | 34,787,200 | 35,125,168 |
| Other current assets | 48,490,267 | 50,343,150 |
| | 99,666,528 | 100,888,871 |
| Equity | 61,704,696 | 61,704,696 |
| Retained earnings | 9,484,114 | 11,052,050 |
| Non-current liabilities | 1,111,803 | 378,724 |
| Current liabilities | | |
| Trade payables | 9,675,272 | 23,056,366 |
| Other current liabilities | 17,690,643 | 4,697,035 |
| | 99,666,528 | 100,888,871 |

## Summary

Traditional book-keeping resulted in the production of a statement of financial position that was simply a list of unused and unpaid balances on account at the close of the financial year. It was intrinsically a document confirming the double entry system but it was used by investors and analysts to assess the risk inherent in the capital structure.

Unfortunately the transaction-based nature of book-keeping created a statement of financial position incapable of keeping pace with a developing financial market of highly sophisticated transactions. By operating within the legal niceties, management was able to keep future benefits and obligations off the statement of financial position. It was also possible for capital instruments of one kind to masquerade as those of another – sometimes by accident, but often by design. This dilution in the effectiveness of the statement of financial position had to be remedied.

The IASB has addressed the problem from first principles by requiring consideration to be given to the definitions of assets and liabilities; to the accounting substance of a transaction over its legal form; to the elimination of off balance sheet finance; and to the standardisation of accounting treatment in respect of items such as leases and capital instruments.

As a consequence, the statement of financial position is rapidly becoming the primary reporting vehicle. In so doing it is tending to be seen as a efinitive statement of assets used and liabilities incurred by the reporting entity.

The process of change is unlikely to be painless, and considerable controversy will doubtless arise about whether a transaction falls within the IASB definition of an asset or liability; whether it should be recognised; and how it should be disclosed. This will remain an important developing area of regulation and the IASB is to be congratulated on its approach, which requires accountants to exercise their professional judgement.

## REVIEW QUESTIONS

**1** Some members of the board of directors of a company deliberating over a possible source of new capital believe that irredeemable debentures carrying a fixed annual coupon rate would suffice. They also believe that the going concern concept of the financial statements would obviate the need to include the debt thereon: the entity is a going concern and there is no intention to repay the debt; therefore disclosure is unwarranted. Discuss.

**2** The Notes in the BG Group 2007 Annual Report included the following extract:

**Provisions for liabilities and charges**

Decommissioning

| | *2007* | *2006* |
|---|---|---|
| | £m | £m |
| As at 1 January | 311 | 260 |
| Unwinding of discount | 16 | 13 |

**Decommissioning costs**

The estimated cost of decommissioning at the end of the producing lives of fields is reviewed at least annually and engineering estimates and reports are updated periodically. Provision is made for the estimated cost of decommissioning at the statement of financial position date, to the extent that current circumstances indicate BG Group will ultimately bear this cost.

Explain why the provision has been increased in 2006 and 2007 by the unwinding of discount and why these increases are for different amounts.

**3** As a sales incentive, a computer manufacturer, Burgot SA, offers to buy back its computers after three years at 25% of the original selling price, so providing the customer with a guaranteed residual value which would be exercised if he or she were unable to achieve a higher price in the second-hand market.

Discuss the substance of this transaction and conclude on how the transaction should be presented in the financial statements of the customer.

**4** A boat manufacturer, Swann SpA, supplies its dealers on a consignment basis, which allows either Swann SpA or a dealer to require a boat to be returned. Each dealer has to arrange insurance for the boats held on consignment.

When a boat is sold to a customer, the dealer pays Swann SpA the lower of:

- the delivery price of the boat as at the date it was first supplied; or
- the current delivery price less the insurance premiums paid to date of sale.

If a boat is unsold after three months, the dealer has to pay on the same terms.

Discuss, with reasons, whether boats held by the dealers on consignment should appear as inventory in the statement of financial position of Swann SpA or the dealer.

**5** Discuss the problems of interpreting financial reports when there are events after the reporting date, and the extent to which you consider IAS 10 should be amended. Illustrate your decisions with practical examples as appropriate.

**6** D Ltd has a balance on its receivable's account of £100,000. Previous experience would anticipate bad debts to a maximum of 3%. The company adopts a policy of factoring its receivables. Explain how the transaction would be dealt with in the books of D Ltd under each of the following independent sets of circumstances:

(i) The factoring agreement involves a sole payment of £95,000 to complete the transaction. No further payments are to be made or received by either party to the agreement.

(ii) The receivables are transferred to the factoring entity on receipt of £93,000. The agreement provides for further payments, which will vary on the basis of timing and receipts from debtors. Interest is chargeable by the factor on a daily basis, based on the outstanding amount at the close of the day's transactions. The factor also has recourse to D Ltd for the first £10,000 of any loss.

**7** Mining, nuclear and oil companies have normally provided an amount each year over the life of an enterprise to provide for decommissioning costs. Explain why the IASB considered this to be an inappropriate treatment and how these companies would be affected by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and ED IAS 37 *Non-financial Liabilities*.

**8** The following note appeared in the Jarvis plc 2004 Annual Report:

**Provision against onerous lease liabilities**
The provision reflects the anticipated costs arising from the Group's decision not to occupy new premises on which it has entered into a long-term lease . . .

Discuss the criteria for assessing whether a contract is onerous.

**9** The following note appeared in the Eesti Telekom 2003 Annual Report:

**Factoring of receivables**
The factoring of receivables is the sale of receivables. Depending on the type of factoring contract, the buyer acquires the right to sell the receivables back to the seller (factoring with recourse) or there is no right to resell and all the risks and rewards are transferred from the seller to the buyer (factoring without recourse).

Explain how the accounting treatment would differ between a non-recourse and a recourse factoring agreement.

## EXERCISES

An extract from the solution is provided on the Companion Website (www.pearsoned.co.uk/elliott-elliott) for exercises marked with an asterisk (*).

### Question 1

(a) Provisions are particular kinds of liabilities. It therefore follows that provisions should be recognised when the definition of a liability has been met. The key requirement of a liability is a present obligation and thus this requirement is critical also in the context of the recognition of a provision. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* deals with this area.

**Required:**
**(i) Explain why there was a need for detailed guidance on accounting for provisions.**
**(ii) Explain the circumstances under which a provision should be recognised in the financial statements according to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.**

(b) World Wide Nuclear Fuels, a public limited company, disclosed the following information in its financial statements for the year ending 30 November 20X9:

The company purchased an oil company during the year. As part of the sale agreement, oil has to be supplied to the company's former holding company at an uneconomic rate for a period of five years. As a result, a provision for future operating losses has been set up of $135m, which relates solely to the uneconomic supply of oil. Additionally the oil company is exposed to environmental liabilities arising out of its past obligations, principally in respect of soil and ground water restoration costs, although currently there is no legal obligation to carry out the work. Liabilities for environmental costs are provided for when the group determines a formal plan of action on the closure of an inactive site. It has been decided to provide for $120m in respect of the environmental liability on the acquisition of the oil company. World Wide Nuclear Fuels has a reputation for ensuring the preservation of the environment in its business activities. The company is also facing a legal claim for $200 million from a competitor who claims they have breached a patent in one of their processes. World Wide Nuclear Fuels has obtained legal advice that the claim has little chance of success and the insurance advisers have indicated that to insure against losing the case would cost $20 million as a premium.

Required:
**Discuss whether the provision has been accounted for correctly under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and whether any changes are likely to be needed under ED IAS 37.**

## Question 2

The directors of Apple Pie plc at the September 20X5 board meeting were expressing concern about falling sales and the lack of cash to meet a dividend for the current year ending 31 December at the same rate as the previous year. They suggested to the finance director that:

- equipment with a book value of £40 million as at the beginning of the year and an estimated useful economic life of three years should be sold for £62.5 million;
- the £62.5 million and £40 million should be included in the sales and cost of sales for the period resulting in an improvement of £22.5 million in profit which would cover the proposed dividend;
- the equipment should then be leased back at 1 October 20X5 for the remainder of its economic life. The commercial rate of interest for a similar lease agreement had been 10%.

Required:
**Draft the finance director's response to their suggestion and indicate the effect on the financial statements as at 31 December 20X5 if the lease agreement is entered into on 1 October 20X5.**

## * Question 3

On 20 December 20X6 one of Incident plc's lorries was involved in an accident with a car. The lorry driver was responsible for the accident and the company agreed to pay for the repair to the car. The company put in a claim to its insurers on 17 January 20X7 for the cost of the claim. The company expected the claim to be settled by the insurance company except for a £250 excess on the insurance policy. The insurance company may dispute the claim and not pay out, however, the company believes that the chance of this occurring is low. The cost of repairing the car was estimated as £5,000, all of which was incurred after the year end.

Required:
**Explain how this item should be treated in the financial statements for the year ended 31 December 20X6 according to both IAS 37 and ED IAS 37 *Non-financial Liabilities*.**

## Question 4

Plasma Ltd, a manufacturer of electrical goods, guarantees them for 12 months from the date of purchase by the customer. If a fault occurs after the guarantee period, but is due to faulty manufacture or design of the product, the company repairs or replaces the product. However, the company does not make this practice widely known.

**Required:**
**Explain how repairs after the guarantee period should be treated in the financial statements.**

## Question 5

In 20X6 Alpha AS made the decision to close a loss-making department in 20X7. The company proposed to make a provision for the future costs of termination in the 20X6 profit or loss. Its argument was that a liability existed in 20X6 which should be recognised in 20X6. The auditor objected to recognising a liability, but agreed to recognition if it could be shown that the management decision was irrevocable.

**Required:**
**Discuss whether a liability exists and should be recognised in the 20X6 statement of financial position.**

## Question 6

Easy View Ltd had started business publishing training resource material in ring binder format for use in primary schools. Later it diversified into the hiring out of videos and had opened a chain of video hire shops. With the growing popularity of a mail order video/dvd supplier the video hire shops had become loss-making.

The company's year end was 31 March and in February the financial director (FD) was asked to prepare a report for the board on the implications of closing this segment of the business.

The position at the board meeting on 10 March was as follows:

1. It was agreed that the closure should take place from 1 April 2010 to be completed by 31 May 2010.
2. The premises were freehold except for one that was on a lease with six years to run. It was in an inner city shopping complex where many properties were empty and there was little chance of sub-letting. The annual rent was £20,000 per annum. Early termination of the lease could be negotiated for a figure of £100,000. An appropriate discount rate is 8%.
3. The office equipment and vans had a book value of £125,000 and it was expected to realise £90,000, a figure tentatively suggested by a dealer who indicated that he might be able to complete by the end of April.
4. The staff had been mainly part-time and casual employees. There were 45 managers, however, who had been with the company for a number of years. These were happy to retrain to work with the training resources operation. The cost of retraining to use publishing software was estimated at £225,000
5. Losses of £300,000 were estimated for the current year and £75,000 for the period until the closure was complete.

A week before the meeting the managing director made it clear to the FD that he wanted the segment to be treated as a discontinued operation so that the Continuing operations could reflect the profitable training segment's performance.

**Required:**
**Draft the finance director's report to present to the MD before the meeting to clarify the financial reporting implications.**

## References


1 K.V. Peasnell and R.A. Yaansah, *Off-Balance Sheet Financing*, ACCA, 1988.
2 IAS 17 *Leases*, IASC, revised 1997.
3 *Framework for the Preparation and Presentation of Financial Statements*, IASC, 1989, para. 49.
4 *Ibid.*, para. 86.
5 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IASC, 1998.
6 *Ibid.*, para. 2.
7 *Ibid.*, para. 25.
8 *Ibid.*, para. 17.
9 *Ibid.*, para. 23.
10 *Ibid.*, para. 36.
11 *Ibid.*, para. 43.
12 *Ibid.*, para. 45.
13 *Ibid.*, para. 47.
14 *Ibid.*, para. 84.
15 B. Singleton-Green, 'Enron – how the fraud worked', *Accountancy*, May 2002, pp. 20–21.