Chapter 11

Provisions and non-current (long-term) liabilities

REAL WORLD CASE

30 Other provisions

$ million

	Group				Parent
	Decommissioning	Environmental	Other	Total	Other provisions
At 1 January 2004	4,720	2,298	1,797	8,815	216
Prior year adjustment – change in accounting policy	–	–	(216)	(216)	(216)
Restated	4,720	2,298	1,581	8,599	–
Exchange adjustments	213	21	25	259	–
New provisions	294	588	298	1,180	–
Write-back of unused provisions	–	(151)	(64)	(215)	–
Unwinding of discount	118	55	23	196	–
Change in discount rate	434	40	1	475	–
Utilized/deleted	(199)	(393)	(294)	(886)	–
At 31 December 2004	5,580	2,458	1,570	9,608	–

The group makes full provision for the future cost of decommissioning oil and natural gas production facilities and related pipelines on a discounted basis on the installation of those facilities. At 31 December 2004, the provision for the costs of decommissioning these production facilities and pipelines at the end of their economic lives was $5,580 million ($4,720 million). The provision has been estimated using existing technology, at current prices and discounted using a real discount rate of 2.0% (2.5%). These costs are expected to be incurred over the next 30 years. While the provision is based on the best estimate of future costs and the economic lives of the facilities and pipelines, there is uncertainty regarding both the amount and timing of incurring these costs.

Decommissioning costs

The group holds provisions for the future decommissioning of oil and natural gas production facilities and pipelines at the end of their economic lives. The largest asset removal obligations facing BP relate to the removal and disposal of oil and natural gas platforms and pipelines around the world. The estimated discounted costs of dismantling and removing these facilities are accrued on the installation of those facilities, reflecting our legal obligations at that time. Most of these removal events are many years in the future and the precise requirements

that will have to be met when the removal event actually occurs are uncertain. Asset removal technologies and costs are constantly changing, as well as political, environmental, safety and public expectations. Consequently, the timing and amounts of future cash flows are subject to significant uncertainty. The timing and amount of future expenditures are reviewed annually, together with the interest rate to be used in discounting the cash flows. The interest rate used to determine the balance sheet obligation at the end of 2004 was 2.0%, 0.5% lower than at the end of 2003. The interest rate represents the real rate (i.e. adjusted for inflation) on long-dated government bonds.

Source: BP Annual Report and Accounts 2004, pp. 67 and 34.

Discussion points

1 Why is there a provision when the decommissioning will take place so far into the future?

2 What are the significant uncertainties in estimating the amount of the provision?

Contents

Learning outcomes

After studying this chapter you should be able to:

- Define a non-current (long-term) liability.
- Explain the needs of users for information about non-current (long-term) liabilities.
- Explain the different types of non-current (long-term) loan finance which may be found in the balance sheets of major companies.
- Understand the purpose of provisions and explain how provisions are reported in financial statements.
- Understand the nature of deferred income and explain how it is reported in financial statements.
- Know the main types of loan finance and capital instruments used by companies and understand the principles of reporting information in the financial statements.

Additionally, for those who choose to study the Supplement to this chapter:

- Prepare the ledger accounts to record provisions and deferred income.

11.1 Introduction

Supplement 7.1 to Chapter 7 sets out the information to be presented on the face of the balance sheet of companies using the IASB system in their financial statements. The non-current liabilities listed there are item (k) provisions, (l) financial liabilities (where these are loans due in more than one year's time) and (n) deferred tax liabilities.

Supplement 7.2 to Chapter 7 sets out the information to be presented in the financial statements of companies that are using the UK Companies Act and UK ASB standards. There is one heading for non-current liabilities, with a detailed list below, as follows:

H Creditors: amounts falling due after more than one year
1 Debenture loans
2 Bank loans and overdrafts
3 Payments received on account
4 Trade creditors
5 Bills of exchange payable
6 Amounts owed to group undertakings
7 Amounts owed to undertakings in which the company has a participating interest
8 Other creditors including taxation and social security
9 Accruals and deferred income

Comparing Supplements 7.1 and 7.2 it could appear that companies using the IASB system face fewer detailed rules. However those companies still produce a great deal of detailed information in practice because the IASB has other standards that require more detail.

In this chapter we follow the pattern established in earlier chapters by asking:

- What are the principles for defining and recognising these items?
- What are the information needs of users in respect of the particular items?
- What information is currently provided by companies to meet these needs?
- Does the information show the desirable qualitative characteristics of financial statements?
- What are the principles for measuring, and processes for recording, these items?

This chapter looks first at provisions, then turns to non-current (long-term) liabilities and finally covers deferred income. General principles of definition and recognition of liabilities are dealt with in Chapter 10 and you should ensure you have read and understood that chapter before embarking on this one. For convenience the definitions from Chapter 2 are repeated here.

Definitions

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.[1]

A **current liability** is a liability which satisfies any of the following criteria:

(a) it is expected to be settled in the entity's normal operating cycle;
(b) it is held primarily for the purpose of being traded;
(c) it is due to be settled within 12 months after the balance sheet date.[2]

A **non-current liability** is any liability that does not meet the definition of a current liability.[3] Non-current liabilities are also described as **long-term liabilities**.

11.2 Users' needs for information

There are two aspects of information needed in relation to liabilities. The first relates to the amount owed (sometimes called the **principal sum** or the **capital amount**) and the second relates to the cost of servicing the loan (usually the payment of **interest**).

Owners of a company need to know how much the company owes to other parties because the owners are at the end of the queue when it comes to sharing out the assets of the company if it closes down. Lenders to the company want to know how many other lenders will have a claim on assets if the company closes down and how much the total claim of lenders will be. They may want to take a **secured loan**, where the agreement with the company specifies particular assets which may be sold by the lender if the company defaults on payment.

Cash flow is important to a range of users. Interest payments are an expense to be reported in the profit and loss account, but paying interest is a drain on cash as well as affecting the ownership interest by a reduction in profit. Owners of the company want to know if there will be sufficient cash left to allow them a **dividend** (or **drawings** for partnerships and sole traders) after interest has been paid. Lenders want to be reassured that the company is generating sufficient cash flow and profit to cover the interest expense.

Both owners and lenders want to see the impact of borrowing on future cash flows. They need to know the scheduled dates of repayments of loans (sometimes referred to as the **maturity profile of debt**), the currency in which the loan must be repaid and the structure of interest rates (e.g. whether the loan period is starting with low rates of interest which are then stepped up in future years).

Finally, owners and lenders are interested in the **gearing** of the company. This means the ratio of loan capital to ownership interest in the balance sheet or the ratio of interest payments to net profit in the profit and loss account. Chapter 13 will provide more detail on the calculation and interpretation of gearing.

Activity 11.1

Imagine you are a shareholder in a company which is financed partly by long-term loans. Write down the information needed by users in the order of importance to you as a shareholder and explain your answer.

11.3 Information provided in the financial statements

The balance sheet of Safe and Sure plc, set out in Chapter 7, contains the following information in relation to non-current (long-term) liabilities:

	Notes	Year 7 £m	*Year 6 £m*
Non-current liabilities			
Amounts payable (creditors)	*9*	(2.7)	*(2.6)*
Bank and other borrowings	*10*	(0.2)	*(0.6)*
Provisions	*11*	(20.2)	*(22.2)*
Net assets		464.3	*370.4*

Notes to the balance sheet explain more about the balance sheet items. Note 9 gives some indication of the type of creditors due after more than one year.

Note 9 Non-current liabilities: payables (creditors)

	Year 7 £m	*Year 6 £m*
Deferred consideration on acquisition	0.6	–
Other payables (creditors)	2.1	*2.6*
	2.7	*2.6*

Note 10 distinguishes secured and unsecured loans among the borrowings due after one year and also gives a schedule of repayment over the immediate and medium-term or longer-term future. For this company, bank borrowings all mature within five years. Note 10 also confirms that commercial rates of interest are payable.

Note 10 Non-current liabilities: bank and other borrowings

	Year 7 £m	*Year 6 £m*
Secured loans	–	*0.3*
Unsecured loans	0.2	*0.3*
	0.2	*0.6*
Loans are repayable by instalments:		
Between one and two years	0.1	*0.2*
Between two and five years	0.1	*0.4*
	0.2	*0.6*

Interest on long-term loans, which are denominated in a number of currencies, is payable at normal commercial rates appropriate to the country in which the borrowing is made. The last repayment falls due in Year 11.

Note 11 gives information on provisions for liabilities which will occur at a future date, as a result of past events or of definite plans made.

Note 11 Provisions

	Year 7 £m	*Year 6 £m*
Provisions for treating contaminated site:		
At 1 January	14.2	*14.5*
Utilised in the year	(2.2)	*(0.3)*
At 31 December	12.0	*14.2*
Provisions for restructuring costs:		
At 1 January	4.2	–
Created in year	1.0	*4.3*
Utilised in year	(1.0)	*(0.1)*
At 31 December	4.2	*4.2*
Provision for deferred tax:		
At 1 January	3.8	*2.7*
Transfer to profit and loss account	0.5	*1.2*
Other movements	(0.3)	*(0.1)*
At 31 December	4.0	*3.8*
Total provision	20.2	*22.2*

Finally, note 33 sets out contingent liabilities. (Contingent liabilities are defined and explained in Chapter 10.) Two contingent items have the amount quantified. The impact of litigation (legal action) is not quantified. The company may think that to do so would be seen as an admission of legal liability.

Note 33 Contingent liabilities

The company has guaranteed bank and other borrowings of subsidiaries amounting to £3.0m (Year 6: £15.2m). The group has commitments, amounting to approximately £41.9m (Year 6: £28.5m), under forward exchange contracts entered into in the ordinary course of business.

Certain subsidiaries have given warranties for service work. These are explained in the statement on accounting policies. There are contingent liabilities in respect of litigation. None of the actions is expected to give rise to any material loss.

The accounting policy statement contains three items relevant to liabilities:

Accounting policies

Deferred tax
The provision for deferred tax recognises a future liability arising from past transactions and events. Tax legislation allows the company to defer settlement of the liability for several years.

Warranties
Some service work is carried out under warranty. The cost of claims under warranty is charged against the profit and loss account of the year in which the claims are settled.

Deferred consideration
For acquisitions involving deferred consideration, estimated deferred payments are accrued in the balance sheet. Interest due to vendors on deferred payments is charged to the profit and loss account as it accrues.

In this extract the word 'charge' appears several times. In relation to interest or taxes, the use of the word **charge** describes the reduction in ownership interest reported in the income statement (profit and loss account) due to the cost of interest and tax payable.

Because the level of borrowing is low in this company, and therefore would not create any concern for investors or new lenders, the finance director has very little to say about it in his report. To some extent the chairman takes the initiative earlier in the annual report:

Finance
Once again, during Year 7 we had a strong operating cash flow, amounting to £196.7m (up from £163.5m in Year 6). This funded expenditure of £24.6m on acquisition of other companies and businesses (after allowing for £3.1m received from a disposal of a company) and the group still ended the year with an increase in its cash balances.

David Wilson has already commented in Chapters 4 and 7 on some aspects of the liabilities in the financial statements of Safe and Sure plc. Here he is explaining to Leona, in the coffee bar at the health club, his views on liabilities in particular.

DAVID: *Where do I start in explaining how I look at liabilities? Well, I always read the accounting policy notes before I look at any financial statements. This company provides three accounting policy notes relating to matters of liabilities. The policy on warranties is interesting because it confirms that the company does not record any expected liability on warranties. The first time I saw this in the annual report I was quite concerned about lack of prudence, but on my first visit to the company I was shown the warranty settlement file. There are very few claims under warranty because the company has lots of procedures which have to be followed by employees who carry out service work. Warranty claims are relatively unusual and unpredictable for this company so there is no previous pattern to justify setting up a liability in the form of a provision for future claims.*

The deferred consideration arises because this company has acquired another business and wants to look into all aspects of the newly acquired investment before making full payment.

Deferred tax provisions are common to many companies. They are an attempt to line up the accounting profit with the tax charge based on taxable profits, which are usually different. I don't understand the technical details but my test of importance is to look at the amount charged to the profit and loss account for the year. It is less than 1% of the profit after tax, so I shan't be giving it much attention on this occasion.

Provisions for restructuring are my real headache. These are a measure of the costs expected when the company plans a restructuring such as changing the management structure with redefinition of the role of some employees and redundancy for others. It sounds reasonable to give warning of what all this will cost but the standard setters have to be strict about the details because in the past the use of provisions has been linked to some creative accounting in the profit and loss account. Do you know anything about that?

LEONA: *Yes. On the one hand, you would like to know that a company is prudent in reporting in the profit and loss account now the likely losses which will arise in future years because of a decision to reorganise. On the other hand, you would not like to think that a company has loaded the profit and loss account with lots of bad news this year so that it can make next year look much better when the results are published. The accounting standard setter has prevented companies from being excessively prudent. I could explain more but not at this time on a Friday night. What do you see in the balance sheet and the other information provided by the company?*

DAVID: *After reading and thinking about the items in the accounting policy notes I look to the breakdown between current liabilities and longer-term liabilities. I also look to the amount of long-term finance compared with the amount of the equity holders' funds. The borrowings in this company are relatively low in relation to equityholders' funds, so there is not a high financial risk, but I still want to look for unexplained changes since the previous year. Again, there is nothing which springs to the eye.*

The contingent liability note is usually quite interesting. One of my senior colleagues says that you should start at the end of the annual report and read it backwards. Then you find the best parts first. The contingent liability note is always near the end. I would be asking lots of questions about the forward exchange contracts, if I had not already asked the financial controller. He confirmed in more detail what the finance director says rather briefly. The forward exchange contracts are used as part of prudent financial management to put a limit on any potential loss through adverse currency movements on transactions in different countries.

LEONA: *Much of what you say is reflected in what auditors carry out by way of analytical review. What we don't provide is a view to the future. What are your thoughts there?*

DAVID: *This is a cash-rich company and it has very little in the way of complicated financial structures. For a major company that is probably unusual, but it means I can concentrate on the operating aspects of the business and on whether it will continue to generate cash. It uses cash generated to buy other businesses and expand further, but I wonder what will happen when the scope for that expansion ceases. It is unlikely to be a problem in the near future because the company has a foothold in expanding markets in Asia. When that scope for expansion comes to an end the company may have to start borrowing to finance expansion rather than relying on internal cash flows.*

11.4 Provisions

Making a provision is an accounting process similar to that of making accrual for a known obligation.

Definition A **provision** is a liability of uncertain timing or amount.[4]

The distinguishing feature of a provision often lies in the larger element of uncertainty which surrounds a provision. Such a provision will appear in the liabilities section of a balance sheet. (This book has already considered in Chapter 8 the provision for depreciation and in Chapter 9 the provision for doubtful debts. These are examples of what is regarded as an adjustment to the reported value of an asset, rather than an adjustment for significant uncertainty. They are therefore reported as adjustments to the asset and do not appear in the liabilities section.) The following are examples of provisions which may be found in the liabilities sections of published accounts:

- losses on contracts
- obsolescence of stock
- costs related to closure of a division of the company
- costs of decommissioning an oil rig
- cost of landscaping a site at the end of the period of use
- warranties given for repair of goods.

Recording a **provision** is relatively straightforward. The ownership interest is reduced by an expense in the profit and loss account and a liability is created under the name of the provision:

Assets – **Liabilities ↑**	equals	**Ownership interest ↓ (expense)**

When the provision is no longer required it is released to the profit and loss account as an item of revenue which increases the ownership interest and the liability is reduced:

Assets – **Liabilities ↓**	equals	**Ownership interest ↑**

The provision may also be released to the profit and loss account so as to match an expense which was anticipated when the provision was made. The effect on the accounting equation is an increase in the ownership interest – the same effect as results from regarding the release of the provision as an item of revenue.

Of the topics covered in this chapter, provisions give the greatest scope for international variation in accounting treatment. In countries where the accounting system and the tax system are linked, there may be specific rules about the level and nature of provisions allowed. In countries that have a strong culture of **conservatism** (strong **prudence**) the provisions may be used to understate profit. The problem with such an approach is that the unnecessary provision may then be released in a year when profits would otherwise be lower. This has the effect of 'smoothing' out the peaks and troughs of profit. Both the IASB and the UK ASB believe that provisions should only be used under carefully defined conditions. This approach also applies in the USA.

The IASB has proposed[5] to change the description of provisions to become 'non-financial liabilities'. If consultation gives a favourable response, this change will take effect from 2007. The IASB has proposed that any items satisfying the definition of a liability should be recognised unless they cannot be measured reliably. Any unconditional obligation would be recognised so there would no longer be a need to estimate the likelihood of the obligation being implemented. Uncertainty about the amount or timing of the economic benefits required to settle the non-financial liability would be recognised in the measurement of the liability.

Example

During the year ending 31 December Year 5, a company's sales of manufactured goods amounted to £1m. All goods carry a manufacturer's warranty to rectify any faults arising during the first 12 months of ownership. At the start of the year, based on previous experience, a provision of 2.5% of sales was made (estimating the sales to be £1m). During Year 5 repairs under warranty cost £14,000. There could be further repair costs incurred in Year 6 in respect of those items sold part-way through Year 5 whose warranty extends into Year 6.

Using the accounting equation, the effect of these events and transactions may be analysed. When the provision is established there is an increase in a liability and an expense to be charged to the profit and loss account:

Assets	–	**Liabilities ↑**	=	**Ownership interest ↓ (expense)**
		+£25,000		–£25,000

As the repairs under warranty are carried out, they cause a decrease in the asset of cash and a decrease in the provision. They do not directly affect the profit and loss account expense:

Assets ↓	–	**Liabilities ↓**	=	Ownership interest
–£14,000		–£14,000		

The overall effect is that the profit and loss account will report an expense of £25,000 but the provision will only be used to the extent of £14,000, leaving £11,000 available to cover any further repairs in respect of Year 5 sales. The repairs, when paid for, decrease the asset of cash but are not seen as decreasing the ownership interest. They are seen as meeting a liability to the customer (rather like making a payment to meet a liability to a supplier). The creation of the provision establishes the full amount of the liability and the decrease in the ownership interest which is to be reported in the profit and loss account.

The spreadsheet for analysis is contained in Exhibit 11.1.

Exhibit 11.1

Spreadsheet for analysis of provision for warranty repairs

Date	*Transaction or event*	*Asset*	*Liability*	*Ownership interest*
		Cash	*Provision*	*Profit and loss account*
Year 5		£	£	£
Jan. 1	Provision for repairs		25,000	(25,000)
Jan.–Dec.	Repairs under warranty	(14,000)	(14,000)	
	Totals	(14,000)	11,000	(25,000)

Activity 11.2

Test your understanding of the previous section by analysing the following information and entering it in a spreadsheet to show analysis of the impact of the information on the accounting equation:

Jan. 1 Year 1	*Make a provision for repairs, £50,000.*
During Year 1	*Spend £30,000 against the provision and carry the rest forward.*
Jan. 1 Year 2	*Make a further provision for repairs, £10,000.*
During Year 2	*Spend £25,000 against the provision and carry the rest forward.*
Jan. 1 Year 3	*Reduce the remaining provision to £3,000.*

11.5 Deferred income

For companies located in areas of the country where there are particular problems of unemployment or a need to encourage redevelopment of the location, the government may award grants as a contribution to the operating costs of the company or to the cost of buying new fixed assets.

Consider the award of a government grant to a company, intended to help with the cost of training employees over the next three years. The asset of cash increases, but there is no corresponding effect on any other asset or liability. Consequently, the ownership interest is increased. The obvious label for this increase is **revenue**. However, the benefit of the grant will extend over three years and it would therefore seem appropriate to spread the revenue over three years to match the cost it is subsidising. The accounting device for producing this effect is to say that the cash received as an asset creates a liability called **deferred income**. This does not meet the definition of a liability stated at the start of this chapter because the practice of deferring income is dictated by the importance of **matching** revenues and costs in the profit and loss account. It is one of the cases where established custom and practice continues because it has been found to be useful although it does not fit neatly into the conceptual framework definitions.

Example

A company receives a grant of £30,000 towards the cost of employee retraining. The retraining programme will last for three years and the costs will be spread evenly over the three years.

The profit and loss account will show revenue of £10,000 in each year. At the outset the deferred income will be recorded in the balance sheet as £30,000. By the end of Year 1 the deferred income will be reduced to £20,000. At the end of Year 2 the deferred income will be reduced to £10,000. At the end of Year 3 the deferred income is reduced to nil. The accounting records are shown in Exhibit 11.2.

Where grants are received towards the acquisition of fixed assets there is a similar approach of spreading the grant over the period during which the company will benefit from use of the asset. Some companies show the revenue as a separate item in the profit and loss account while others deduct it from the depreciation expense. This is a matter of presentation which makes no difference to the overall profit. The balance sheet treatment is more controversial. Some companies report separately the net book value of the asset and the deferred income. Others deduct the deferred income from the net book value of the asset. This does not affect the ownership interest but shows a lower amount in the fixed assets section of the balance sheet. In consequence, the user who calculates profit as a percentage of fixed assets or a percentage of total assets will obtain a higher answer where a company shows the lower amount for net assets. Most companies report the asset and deferred income separately, but some argue for

Exhibit 11.2
Recording deferred income and transfer to revenue

Date	*Transaction or event*	*Asset*	*Liability*	*Ownership interest*
		Cash	*Deferred income*	*Revenue*
Year 1		£	£	£
Jan. 1	Receiving the grant	30,000	30,000	
Dec. 31	Transfer to profit and loss account of first year's revenue		(10,000)	10,000
Year 2				
Dec. 31	Transfer to profit and loss account of second year's revenue		(10,000)	10,000
Year 3				
Dec. 31	Transfer to profit and loss account of third year's revenue		(10,000)	10,000

the **net** approach which sets one against the other. (Both methods are permitted by the international accounting standard and by the UK national standard. There is a view that the net approach may not be complying with the Companies Act 1985 and so relatively few UK companies have taken the net approach.) The choice will be set out in the notes on accounting policies. This is a useful illustration of the importance of reading the note on accounting policies.

Activity 11.3

Consider a grant received as a contribution to staff retraining costs over the next three years. Write down three arguments in favour of reporting the entire grant in the profit and loss account in the year it is received and write down three arguments in favour of spreading the grant across the period of retraining. Which set of arguments do you find more persuasive?

11.6 Non-current (long-term) liabilities

The balance sheet requires a separate heading for all liabilities payable after one year. Users of financial statements need information about when the liabilities will be due for repayment (the **maturity** pattern).

Users also need to know about the nature of the liability and any risks attaching to expected outflows of economic benefit from the liability. The risks lie in: the interest payable on the loan; the currency of the loan; and the eventual amount to be repaid to the lender. Interest payable may be at a fixed rate of interest or a variable rate of interest. The currency of borrowing is important when foreign exchange rates alter. Repayment amounts may equal the amount borrowed initially, in some cases. In other cases there may be a **premium** (an extra amount) payable in addition to the sum borrowed. There are some very complex accounting aspects to reporting non-current (long-term) liabilities, the technical aspects of which are well beyond the capacity of a first-level text, but they are all directed towards ensuring that liabilities are recorded in full and the matching concept is observed in relation to interest charges.

Users want to know about the risks of sacrificing particular assets if the loan is not repaid on the due date. A claim to a particular asset may be made by a creditor who has a loan **secured** on a particular asset or group of assets.

11.6.1 Recording and measurement

This section concentrates on the terminology of non-current (long-term) liabilities and the general issues of recording and measurement that they raise. The basic feature of non-current (long-term) loan finance is that it is:

- provided by a lender for a period longer than one year;
- who expects payment of interest at an agreed rate at agreed points in time; and
- expects repayment of the loan on an agreed date or dates.

The names given to loan capital vary depending on the type of lender, the possibility that the loan will be bought and sold like ordinary shares, the currency in which the loan has been provided and the legal form of the documents creating the loan. Some of the names you will see are: loan stock, debentures, bonds, commercial paper, loan notes and bank facility.

- **Loan stock**. The word **stock** is used in more than one context in accounting, which is potentially confusing. In Chapter 9 you saw the word used to describe goods held by a company for use or sale to customers. In the phrase **loan stock** it is used to describe an investment held by a lender. In the USA the problem has been avoided by using the word **inventories** to describe goods held for use or sale and using the word **bond** to describe loan stock. If a company shows loan stock in its balance sheet this usually indicates that the stock is available for purchase and sale, in a manner similar to the purchase and sale of shares in a company.
- **Debenture**. The legal meaning of the term **debenture** is a written acknowledgement of a debt. This means there will be a contract, in writing, between the company and the lender. The contract is called the debenture deed and is held by a trustee who is required to look after the needs of the lenders. If the company does not pay interest, or repay capital, on the due date, the trustee must take action to recover what is owed to the lenders. Debentures may be secured or unsecured, depending on what is stated in the debenture deed.
- **Bond** The term **bond** has been in common use in the USA for some time as a name for loan capital. It is now found increasingly frequently in the balance sheets of UK companies, particularly when they are raising finance in the international capital markets where the US terminology is more familiar.
- **Commercial paper**, **loan notes** and **bank facility**. These are all names of short- to medium-term financing provided by banks or similar organisations. The interest payable is usually variable and the loans are unsecured.

This is only a sample of the main variations of names given to loan finance. It is not exhaustive because the name does not matter greatly for the purposes of accounting records and interpretation. The essential information needed for the users of accounting information is the answer to five questions:

1. How much was borrowed (the **principal sum**)?
2. How much has to be repaid (the capital sum plus any additional interest charge)?
3. When is repayment required?
4. What are the interest payments required?
5. Has the lender sought any security for repayment of the interest and the principal sum?

For companies applying the IASB system of accounting, the relevant standard required companies to provide information about the extent and nature of financial

liabilities, including the significant terms and conditions and the timing of future cash flows. For companies that do not apply the IASB system, the UK Companies Act required disclosure of the total amount in respect of which any security has been given, and an indication of the nature of the security, plus the interest payable and terms of repayment for each category of loan.

Under either set of rules you will find detailed notes to tbe balance sheet setting out the interest costs and repayment conditions for loans reported as liabilities.

11.6.2 Secured and unsecured loans

- **Unsecured loan**. An unsecured loan is one where the lender has no first claim on any particular assets of the company and, in the event of default, must wait for payment alongside all the other unsecured creditors. If there is no wording to indicate that the loan is secured, then the reader of financial statements must assume it is unsecured.
- **Secured loan**. Where any loan is described as **secured**, it means that the lender has first claim to named assets of the company. Where a debenture is secured, and the company defaults on payment, the trustee for the debenture will take possession of the asset and use it to make the necessary repayment. In the event of the company not being able to pay all the amounts it owes, secured lenders come before unsecured lenders in the queue for repayment.

Activity 11.4

A financial weekly magazine contains the following sentence:

> Telecoms plc this week raised cash by selling $1m bonds with five-year and ten-year maturities.

Explain each part of the sentence.

11.6.3 Loan having a range of repayment dates

When a loan is made to a business, conditions will be negotiated regarding the amount and date of repayment. Some banks are willing to offer a range of repayment dates, say any time between 10 and 15 years hence, with the company being allowed to choose when it will repay. If the company needs the money and the interest rate is favourable, the company will borrow for the longest period allowed under the contract. If the company finds it no longer needs the money, or else the interest rate is burdensome, the company will repay at the earliest possible opportunity. For balance sheet purposes the preparer of accounts has to decide which date to use as a basis for classification.

The general principle is that if there is an obligation to transfer economic benefits, there will be a liability in the balance sheet. Where there is a range of possible dates for repayment, the maturity date will be taken as the earliest date on which the lender can require repayment.[6]

11.6.4 Change in the nature of finance source

Some types of finance provided to a business may be arranged so as to allow a change in the nature of the source during the period of financing. As an example, consider the case of convertible loans.

A **convertible loan** is a source of finance which starts its life as a loan but, at some point in the future, may be converted to ordinary shares in the company (e.g. the

lender is promised five shares per £100 of loan capital). At the date of conversion, the lender becomes a **shareholder**. This kind of financial arrangement is attractive to those providing finance because it provides the reassurance of loan finance and a payment of interest in the early years of a new development, with the option of switching to shares if the project is successful. If the project is not successful and the share price does not perform as expected, then the lender will not convert and will look for repayment of the loan on the due date. For the company there are some tax advantages of issuing loan finance. Also, the rate of interest required by investors in a convertible loan is usually lower than that required for a straight (non-convertible) loan because investors see potential additional rewards in the convertible loan.

While a convertible loan remains unconverted it is reported as a loan. Companies are not allowed to say, 'We are almost certain there will be a conversion', and report the convertible loan as share finance from the outset. However, there is an awareness that the eventual conversion will dilute the existing shareholders' claim on future profits and so the company will report the earnings per share before and after taking into account the effect of this dilution. Consequently, you will see 'fully diluted earnings per share' at the foot of the profit and loss account.

11.6.5 Interest payable on the loan

Companies and their banks may negotiate a variety of patterns for interest payment on loans. The pattern of interest payment might be based on a low percentage charge in earlier years and a higher percentage charge in later years, because the company expects that profits will be low initially but will rise later to cover the higher interest payments. For many years the profit and loss account would have reported the interest charge based on the amount paid in each year, but now the standard setters require the interest charge to be reported as it would be if a compound interest rate were applied over the life of the loan. This is described as the **effective interest rate**.[7]

Definition

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument.

The reasoning behind this approach is that, for purposes of reporting profit, the flexibility of negotiation of interest payment patterns makes comparability difficult to achieve. The banks will, however, ensure that they receive the overall compound interest they require and this gives a commercially relevant basis for comparability in the matching of interest charges against the profits of the period.

The general principle is that the amount shown as the expense of interest payable in the profit and loss account should be based on the compound rate of interest applying over the entire period of the loan. This will not always be the same as the amount of interest paid in cash during the period. The spreading of interest charges over the period of the loan is an application of the accruals or matching concept. As an example, consider stepped bonds and deep discount bonds.

Stepped bonds

A **stepped bond** is a form of lending where the interest rate increases over the period of the loan. Take as an example a loan of £5m which carries a rate of interest of 8% per annum for the first three years, 10% per annum for the next three years and 13% per annum for the final four years. The cash payment for interest starts at £400,000 and by the tenth year has risen to £650,000. The overall payments may be shown to be equivalent to a compound rate of 10.06% per annum. Exhibit 11.3 shows that the profit

and loss account charge of £503,000 would start higher than the cash amount, £400,000. By the final year the profit and loss account charge of £517,000 would be lower than the cash amount, £650,000. The pattern followed on each line of Exhibit 11.3 is to start with the amount owing, add interest at 10.06% and deduct the amount of the cash payment, leaving the amount owing at the end of the period which becomes the amount owing at the start of the next period. By the end of the ten years the amount owing is exactly £5,000,000, the amount required by the lender.

It may be seen from Exhibit 11.3 that the expense charged in the income statement (profit and loss account) has a smoother pattern than that of the cash payments. Over the life of the loan the total expense charged must equal the total of the cash payments. The accounting processes for recording these amounts are too complex for a first-level course. The important point to note is that all companies are required to use this approach in calculating the expense charged in calculating profit. The cash flow implications of interest payments may be quite different and it will be necessary to look to the cash flow statement for evidence of the cash flow effect.

Exhibit 11.3

Calculation of expense charged in income statement (profit and loss account) for interest based on compound interest calculation

Year	*Loan at start*	*Expense charged*	*Cash payment record*	
		Interest at 10.06%	*Cash paid*	*Loan at end*
	(a)	(b)	(c)	(a) + (b) – (c)
	£000s	*£000s*	*£000s*	*£000s*
1	5,000	503	400	5,103
2	5,103	513	400	5,216
3	5,216	525	400	5,341
4	5,341	537	500	5,378
5	5,378	541	500	5,419
6	5,419	545	500	5,464
7	5,464	550	650	5,364
8	5,364	540	650	5,254
9	5,254	529	650	5,133
10	5,133	517	650	5,000
Total		*5,300*	*5,300*	

Deep discount bonds

A **deep discount bond** is issued at a price lower than (at a 'discount' to) its repayment amount. The interest rate (**coupon**) paid during the life of the loan may be very low (a 'low coupon' bond) or there may be no interest paid at all during the period of the loan (a 'zero coupon' bond). As an example, consider a zero coupon bond issued at £28m with a redemption value of £41m in four years' time. The cash payments of interest are zero but the profit and loss account would show an annual charge of 10% per annum (starting at £2.8m in Year 1 and rising to £3.73m by Year 4). If there were no pattern of annual interest the entire discount of £13m would be shown as

an expense of Year 4, distorting the underlying pattern of trading profit. Exhibit 11.4 shows the pattern of interest charges for the profit and loss account.

Exhibit 11.4
Schedule of interest charges for zero coupon bond

Year	*Loan at start* £m	*Interest* £m	*Loan at end* £m
1	28.00	2.80	30.80
2	30.80	3.08	33.88
3	33.88	3.39	37.27
4	37.27	3.73	41.00
Total		13.00	

In the balance sheet the amount recorded for the liability will start at £28m and rise to £41m as shown in the final column of Exhibit 11.4, so that the liability at the end represents the total amount due.

Activity 11.5

A three-year loan of £100,000 will be repaid at the end of three years as £133,100. No interest is payable during the three-year period. The interest included in the loan repayment arrangement is equivalent to a compound annual charge of 10% per annum. Explain how this transaction would appear in the profit and loss account and balance sheet over the three-year period.

11.6.6 Complex capital instruments

It is impossible to read the balance sheet of most major listed companies without realising rapidly that there is a bewildering array of capital instruments being used to raise money for business. The reasons are complex but lie in the need to provide conditions which are attractive to both borrower and lender when they may be based in different countries and may have different perspectives on interest rates and currency exchange rates. This section explains the term 'interest rate swaps', which are increasingly used by companies, and takes an illustration from a major company to indicate the variety of capital instruments (sources of finance) in use. Detailed descriptions and discussion are beyond the scope of this text but would be found in a finance manual.

Interest rate swaps

Suppose there are two companies, A and B. Both have identical amounts of loan finance. Company A is paying fixed rates of interest, but would prefer to be paying variable rates, while Company B is paying variable rates of interest, but would prefer to be paying fixed rates. The reasons could be related to patterns of cash flow from trading, cash flow from investments or beliefs about future directions of interest rates. Whatever the reason, it would seem quite acceptable for them to swap (exchange) so that A pays the variable interest on behalf of B and B pays the fixed interest on behalf of A. This type of arrangement has to be explained carefully because neither company can escape from the legal obligation on the loans taken out initially. The explanation will usually be found in a note to the accounts which gives information on the legal obligation and on the actual impact on the profit and loss account of implementing the swap.

Capital instruments of a listed company

The following illustration is based upon the balance sheet of a major UK listed company:

Note on borrowings:		*Year 2* £m	*Year 1* £m
Unsecured borrowings:			
$10^{1}/_{2}$% euro-sterling bonds Year 17		100.0	100.0
Loan stocks			
13.625%	Year 16	25.0	25.0
5.675% – 9.3%	Year 3/Year 10	5.9	6.1
Zero coupon bonds Year 3		96.6	87.2
Variable rate multi-option bank facility		15.8	155.2
Bank loans, overdrafts, commercial paper, short- and medium-term notes		257.0	244.8

. . . the nominal value of the zero coupon bonds is £100m and the effective annual rate of interest is 10.85% . . .

Comment. The euro-sterling bonds and the loan stocks are reported at the amount due for repayment at the end of the loan period. The euro-sterling bonds are loans raised in the eurobond market, repayable in sterling. Those loans which have fixed rates of interest are indicated in the table by a fixed percentage rate. Zero coupon means a zero percentage rate of annual interest payable. That does not mean the company escapes interest payment altogether. The liability on the zero coupon bonds increases by 10.85% each year as indicated in the extract note at the foot of the table. It is presumably due for repayment part-way through Year 3 since the liability shown at the end of Year 2 is quite close to the £100m amount due (called the **nominal value** in the note). The remaining loans are variable rate and so the annual interest charge depends on current rates of interest. Professional investors might want to know more about the nature of the bank facility and also the breakdown of the various components of the figure £257m.

11.7 Summary

- A **non-current liability** is any liability that does not meet the definition of a current liability. Non-current liabilities are also described as **long-term liabilities**.
- Users need information about the **principal sum** repayable and the **interest** payable during the lifetime of a liability. They also need to know the dates on which significant payments will be required (called the **maturity profile of debt**).
- Detailed information about **non-current liabilities** is found in the notes to the financial statements.
- A **provision** is a liability of uncertain timing or amount. The amount of a provision is reported in the liabilities section of a balance sheet. Changes in provisions are reported in the income statement (profit and loss account).
- **Deferred income** arises where a business receives a government grant or receives cash for goods or services before these are provided. The cash received is reported as an increase in cash and an increase in a liability to represent the obligation to satisfy the conditions of the grant or provide the goods or services. When the conditions are satisfied the liability is reduced and the ownership interest is increased by recording the revenue.

QUESTIONS

The Questions section of each chapter has three types of question. 'Test your understanding' questions to help you review your reading are in the 'A' series of questions. You will find the answers to these by reading and thinking about the material in the book. 'Application' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in problem solving and evaluation are in the 'C' series of questions. A letter [S] indicates that there is a solution at the end of the book.

A Test your understanding

Skills outcomes

A11.1 Explain why a provision may be required. (Section 11.4)

A11.2 Give three examples of situations which may lead to provisions. (Section 11.4)

A11.3 Explain how deferred income is recorded. (Section 11.5)

A11.4 Is it justifiable to report deferred income under the category of liability? (Section 11.5)

A11.5 Explain what is meant by each of the following terms: (Section 11.6)

(a) loan stock;
(b) debenture;
(c) bond;
(d) maturity date; and
(e) convertible loan stock.

A11.6 [S] On reviewing the financial statements, the company accountant discovers that a grant of £60,000 towards expenditure of the current year plus two further years has been reported entirely as revenue of the period. What will be the effect on the profit and loss account and the balance sheet when this error is rectified?

A11.7 [S] On reviewing the financial statements, the company accountant discovers that there has been no provision made for urgent repairs to external doors and window frames, already identified as being of high priority on grounds of health and safety. The amount of £50,000 should be provided. What will be the effect on the profit and loss account and the balance sheet when this error is rectified?

B Application

B11.1 [S]
The Washing Machine Repair Company gives a warranty of no-cost rectification of unsatisfactory repairs. It has turnover from repair contracts recorded as:

Year	*Amount of turnover*
	£
1	80,000
2	90,000

Based on previous experience the manager makes a provision of 10% of turnover each year for warranty costs. In respect of the work done during years 1 and 2, repairs under warranty are carried out as follows:

Date of repair work	*Amount in respect of Year 1 turnover*	*Amount in respect of Year 2 turnover*	*Total*
	£	£	£
1	4,500		4,500
2	3,200	4,800	8,000
3		5,000	5,000

Required

(a) Show how this information would be recorded in the financial statements of the Washing Machine Repair Company.

(b) Explain how the financial statements would appear if the company made no provision for warranty costs but charged them to profit and loss account when incurred.

B11.2 [S]

General Engineering Ltd receives a government grant for £60,000 towards employee training costs to be incurred evenly over the next three years. Explain how this transaction will be reported in the financial statements.

C Problem solving and evaluation

C11.1

Explain why each of the following is recognised as a provision in the balance sheet of a telecommunications company:

(a) On 15 December Year 2, the Group announced a major redundancy programme. Provision has been made at 31 December Year 2 for the associated costs. The provision is expected to be utilised within 12 months.

(b) Because of the redundancy programme, some properties have become vacant. Provision has been made for lease payments that cannot be avoided where sub-letting is not possible. The provision will be utilised within 15 months.

(c) There is a legal claim against a subsidiary in respect of alleged breach of contract. Provision has been made for this claim. It is expected that the provision will be utilised within 12 months.

C11.2

(Refer also to Chapter 10, section 10.3.2, on Contingent liabilities.)

Explain why each of the following is reported as a contingent liability but not recognised as a provision in the balance sheet.

(a) Some leasehold properties which the group no longer requires have been sub-let to third parties. If the third parties default, the group remains responsible for future rent payments. The maximum liability is £200,000.

(b) Group companies are defendants in the USA in a number of product liability cases related to tobacco products. In a number of these cases, the amounts of compensatory and punitive damages sought are significant.

(c) The Department of Trade and Industry has appointed Inspectors to investigate the company's flotation ten years ago. The directors have been advised that it is possible that circumstances surrounding the flotation may give rise to claims against the company. At this stage it is not possible to quantify either the probability of success of such claims or of the amounts involved.

Activities for study groups

Turn to the annual report of a listed company which you have used for activities in previous chapters. Find every item of information about liabilities. (Start with the financial statements and notes but look also at the operating and financial review, chief executive's review and other non-regulated information about the company.)

As a group, imagine you are the team of fund managers in a fund management company. You are holding a briefing meeting at which each person explains to the others some feature of the companies in which your fund invests. Today's subject is liabilities. Each person should make a short presentation to the rest of the team covering:

(a) The nature and significance of liabilities in the company.
(b) The effect on profit of a 10% error in estimation of any one of the major categories of liability.
(c) The company's comments, if any, on its future obligations.
(d) The risks which might attach to the liabilities of the company.
(e) The liquidity of the company.
(f) The trends in liabilities since last year (or over five years if a comparative table is provided).
(g) The ratio of current assets to current liabilities.

Notes and references

1. IASB (1989), *Framework*, para. 49(b).
2. IASB (2004) IAS 1, para. 60.
3. IASB (2004) IAS 1, para. 60.
4. IASB (2004), IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, para. 10.
5. IASB (2005), Exposure draft of proposed amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets, para. 1.
6. *Ibid.*, para. 34.
7. IASB (2004), IAS 39 *Financial Instruments: Recognition and Measurement*. Definitions section.

Bookkeeping entries for provisions and deferred income

Provisions

In the main text of this chapter there is an example based on the recording of provision for repairs under warranty. The analysis of the transactions and events is set out in Exhibit 11.1. The ledger account will appear as follows:

L3 Provision for warranty repairs

Date	*Particulars*	*Page*	*Debit*	*Credit*	*Balance*
Year 5			£	£	£
Jan. 1	Provision in respect of Year 5	L2		25,000	(25,000)
Jan.–Dec.	Repairs carried out	L1	14,000		(11,000)

LEONA: *At the start of the year (or possibly in practice at the end of each month) the provision is recorded by debiting the profit and loss account (L2) and crediting the provision. When the repairs are carried out there is a credit entry in the cash account (L1) and a debit entry in the provision account. Nothing is recorded as a profit and loss account expense at that time. The overall effect is that the profit and loss account carries an expense of £25,000 and the provision account shows a potential liability of £11,000 to cover any further repairs arising from work done during Year 5 (since some of the goods sold will remain under warranty into Year 6).*

Deferred income

In the main text of this chapter there is an example based on the recording of deferred income arising under a grant. The analysis of the transactions and events is set out in Exhibit 11.2. The ledger account will appear as follows:

L3 Deferred income (balance sheet)

Date	*Particulars*	*Page*	*Debit*	*Credit*	*Balance*
Year 1			£	£	£
Jan. 1	Grant received	L1		30,000	(30,000)
Dec. 31	Transfer to profit and loss account	L2	10,000		(20,000)
Year 2					
Dec. 31	Transfer to profit and loss account	L2	10,000		(10,000)
Year 3					
Dec. 31	Transfer to profit and loss account	L2	10,000		nil

LEONA: *The deferred income account is reported as a liability in the balance sheet. It is established by a credit entry matched by a debit in the cash account (L1). Each year there is a transfer of one-third to the profit and loss account (L2) so that the revenue is spread evenly over the period.*

S Test your understanding

S11.1 Prepare bookkeeping records for the information in question **B11.1**.

S11.2 Prepare bookkeeping records for the information in question **B11.2**.