

ACCOUNTING FOR PROVISIONS -- TUTORIAL EXAMPLE

Clean plc is a company that is incorporated in the UK . The company prepares its financial statements in accordance with UK accounting standards . On 25th June 2002 , Clean plc made a public announcement of a decision to reduce the level of emissions of harmful chemicals from its factories . The average useful economic lives of the factories on 30th June 2002 (the accounting reference date of the company) was 20 years . The depreciation of the factories is computed on a straight line basis and charged to cost of sales . The directors formulated the proposals for emission reduction following agreement in principle earlier in the year .

The directors prepared detailed estimates of the costs of their proposals and these showed that estimated expenditure of 30 million would be required which will be paid on 30th June 2005 .

The company has a reputation of fulfilling its financial commitments after it has publicly announced them . The annual discount rate used by the company is 8%

Clean plc has included a provision for the expected costs of the proposal in its financial statements for the year ended 30th June 2002

REQUIREMENT

- (A) Explain the decision by the directors of Clean plc to recognise the provision in the balance sheet at 30th June 2002 . You should refer to the provisions of relevant accounting standards
- (B) Compute the balances to be included in the financial statements of Clean plc for the years ended 30th June 2002 , 2003 , 2004 and 2005

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(a) FRS 12: Provisions, Contingent Liabilities and Contingent Assets states that a provision should be recognised if all the following conditions are met:

- (i) There is a present obligation to transfer economic benefits as a result of a past event
- (ii) It is probable that a transfer of economic benefits will be required to settle the obligation
- (iii) A reliable estimate can be made of the obligation

Two of the three conditions are clearly met. Clean plc will incur expenditure and the directors have prepared an estimate of the amount, which can be assumed to be reliable.

Although Clean plc is not legally obliged to carry out the project, it appears that it has a CONSTRUCTIVE OBLIGATION to do so as the company has a reputation of fulfilling its financial commitments once they have been announced publicly.

Thus, the obligating event is the announcement of the obligating event on 25th June 2002 and hence Clean plc is required to recognise a provision.

(W1) Y/E 30-6-2002

$$\text{Provision at 30-6-02} = \frac{30m}{(1.08)^3} = 23,814,965$$

Dr Fixed Assets (factories) 23814965

Cr provision 23814965

$$\text{Depn (per year)} = 23814965 / 20 = 1,190,748$$

(W2) Y/E 30-6-2003

$$\text{Provision at 30-6-03} = \frac{30m}{(1.08)^2} = 25720163$$

Dr Finance Charges 1905198

Cr Provision 1905198

(3)

BALANCE SHEET (EXTRACT)

	2002	2003	2004	2005
	£	£	£	£
Provisions for liabilities and charges	23814965	25720163	27777777	—
Fixed Assets	22624217	21433469	20242721	19051973

PROFIT AND LOSS ACCOUNT (EXTRACT)

	2002	2003	2004	2005
	£	£	£	£
Depreciation	1190748	1190748	1190748	1190748
Finance Charges	—	1905198	2057614	2222223

W3 Y/E 30-6-2004

$$\text{Prov'n at 30-6-04} = \frac{30m}{1.08} = 27777777$$

Dr Finance charges 2057614

Cr Prov'n 2057614

W4 Y/E 30-6-2005

$$\text{Prov'n at 30-6-05} = 30,000,000$$

Dr Finance charges 2222223

Cr prov'n 2222223

This is then paid off.

Dr prov'n 30000000

Cr Bank 30000000