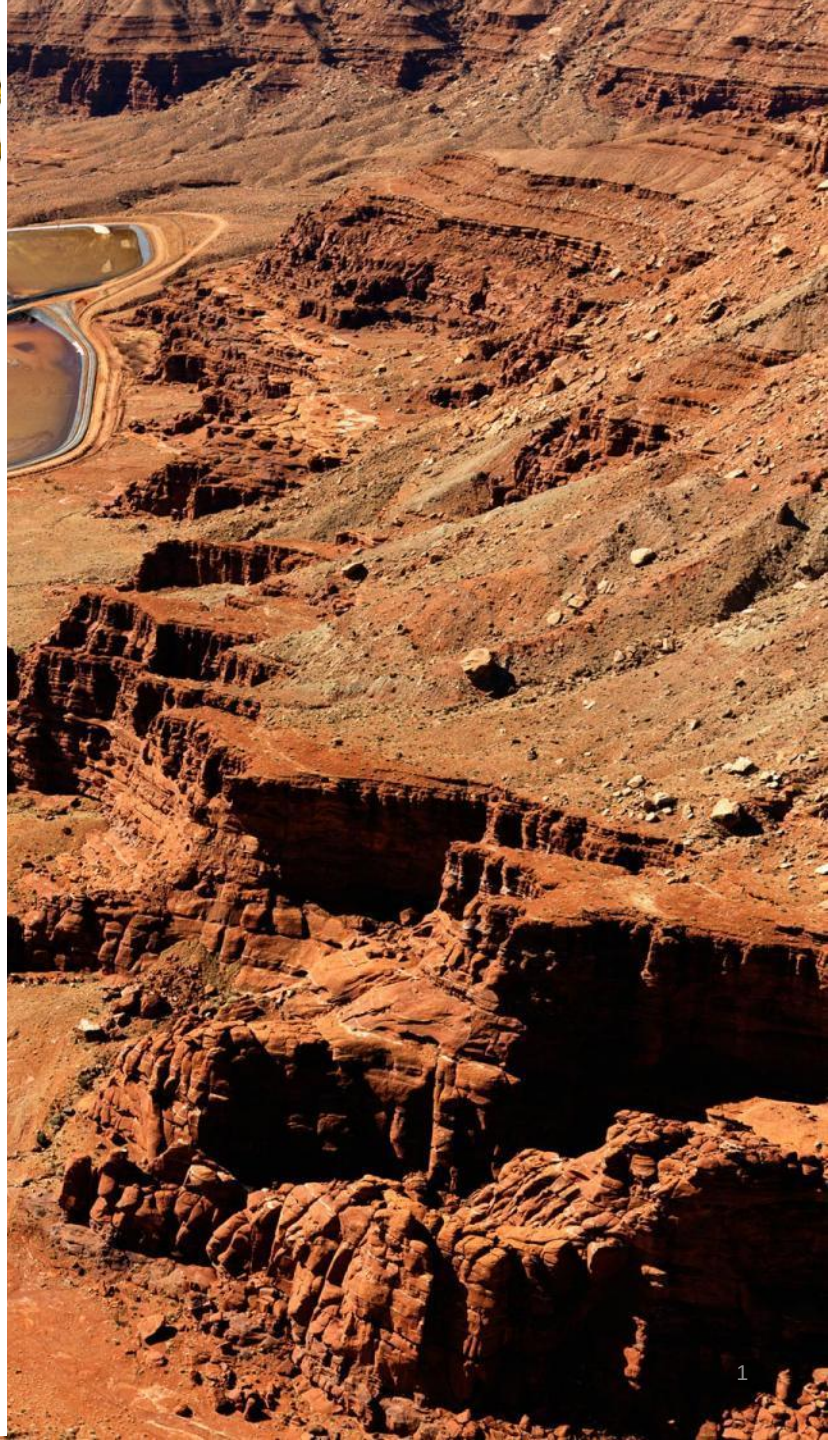
Provisions and Borrowings



Provisions, Contingent Liabilities and Contingent Assets

Measurement of provisions

A provision is measured at the amount that the entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

- *risks and uncertainties are taken into account in the measurement of a provision.*
- *if measured using risk adjusted cash flow forecasts a provision is discounted to its present value.*

Measurement of provisions continued

Measure provision at ‘best estimate’ of the amount required to settle the obligation at the reporting date, ie

- amount an entity would rationally pay to settle the obligation at the end of the reporting period; or
- to transfer it to a third party at that time

Review provisions at each reporting date and adjust them to reflect the current best estimate at that reporting date

- unwinding of the discount is a finance cost

Examples—measurement of provisions

Ex 1: *A has 1,000 units of a product sold with active warranties (i.e. A will repair defects found up to 6 months after sale).*

Probabilities & repair cost: major defect = 5% chance of CU400 repair; minor defect = 20% chance of CU100 repair; 75% chance of no defects.

Best estimate (expected value) = CU40,000

Calculation: (75% x 1,000 units x nil) +

(20% x 1,000 units x CU100) +

(5% x 1,000 units x CU400)

Examples—measurement of provisions continued

Ex 2: *Personal injury lawsuit brought by customer. Lawyers estimate 30% chance compensation = CU2,000,000 & 70% chance = CU300,000.*

Ruling expected in 2 years. Discount rate = 4% per year (ie 2-year government bonds = 5% less 1% risks specific to liability).

Individual most likely outcome = CU300,000. Because only other possible outcome is higher, the best estimate to settle the obligation at 31/12/20X1 will be higher than PV of the most likely outcome of CU300,000, eg PV of CU810,000 at 4% = ±CU748,890

Examples—measurement of provisions continued

Ex 3: *Provision for a lawsuit = CU40,000 at 31/12/20X1 & remeasured to CU90,000 at 31/12/20X2. CU3,000 of the increase = unwinding of the discount & the remainder is for better information becoming available.*

The increase of CU50,000 will be recognised as an expense in the determination of the entity's profit or loss for the year ended 31/12/20X2

- CU3,000 = finance cost
- CU47,000 = change in estimate

Judgements and estimates

Measuring a provision requires estimating the amount that the entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

> *the risks and uncertainties that inevitably surround many events and circumstances are taken account in measuring a provision (eg measure a provision at its expected value by weighing all possible outcomes by their associated probabilities).*

Borrowing Costs

Objective and Scope

Borrowing costs: “interest and other costs that an entity incurs in connection with the borrowing of funds”

Qualifying assets: those that require substantial time to get ready for their intended use or sale

e.g.,

- inventory,
- PP&E,
- intangible assets,
- investment property

Recognition

Recognize borrowing costs (during construction or production) on qualifying assets as part of the cost of those assets as long as:

1. they will result in future benefits
2. they can be measured reliably

- Borrowing costs to capitalize = the avoidable costs, i.e., those that would not have been incurred if expenditures for the qualifying asset had not been made, less any investment income earned on the temporary investment of such funds.

Recognition (Contd.)

If borrowing is specific to a qualifying asset, avoidable costs are easy to calculate

If not asset-specific borrowing:

1. Calculate a capitalization rate
2. Calculate the weighted average expenditures on the qualifying asset
3. Calculate the costs to capitalize

Period of capitalisation

Capitalisation shall commence when expenditures for assets and borrowing costs are being incurred and activities are necessary to prepare the asset for its intended use or sale are in progress

Capitalisation should cease when the asset is substantially complete, or when no work is being carried out for an extended period

Illustrative Example: Capitalisation of borrowing costs

On 1 January 2012, X began to construct a supermarket. It purchased a leasehold interest in the site for €25 million. The construction of the building cost €9 million and the fixtures and fittings cost €6 million. The construction of the supermarket was completed on 30 September 2012 and it was available for use from 1 January 2013.

X borrowed €40 million on 1 January 2012 in order to finance this project. The loan carried interest at 10% per annum. It was repaid on 30 June 2013.

Requirement

Calculate the total amount to be included in property, plant and equipment in respect of the development at 31 December 2012.

Illustrative Example: Capitalisation of borrowing costs

Solution:

The total amount to be included in property, plant and equipment at 31 December 2012 is:

	€
Lease	25m
Building	9m
Fixtures and Fittings	6m
Interest (€40m x 10% x 9/12)	3m
Carrying value	43m

Only 9 months' interest can be capitalised. IAS 23/IPSAS 5 states that capitalisation must cease when substantially all the activities necessary to prepare the assets for its intended use or sale are complete. No depreciation is charged, because the supermarket was not available for use until 1 January 2013.

Illustrative Example 2

In January 2012, Yellow commenced a programme to extend and modernise the company's manufacturing facilities. The programme cost £1,000,000 and Yellow financed the work through a mixture of general and specific debt. The directors' estimate was that 50% of the programme was financed by general debt and 50% by specific debt. Yellow's current general borrowing rate is 10% per annum while the specific debt carries an interest rate of 15% per annum. The programme was completed in December 2012.

Requirement

Explain how Yellow should account for the borrowing costs in the financial statements for the year ended 31 December 2012.

Illustrative Example 2– Suggested solution

This will be added to the capital cost of the work and depreciated.

Working	£
£1,000,000 x 50% x 10%	50,000
£1,000,000 x 50% x 15%	75,000
	125,000

Disclosure

Disclose:

1. The amount of borrowing costs capitalized during the period, and
2. The capitalization rate used to determine the costs eligible for capitalization

Deloitte Q&A