FINANCIAL ACCOUNTING 700 **Seminar RS 6 – Provisions, contingent liabilities and contingent assets** ***PH Ferreira***	**DEPARTMENT OF ACCOUNTING** **UP**

Prescribed works:

1.	IAS 37	-	IASB
2.	GAAP Handbook Volume 1 - Chapter 22	-	Pretorius, **et al**

Questions:		**Time**
Question 1	Provisions, contingent liability	± 15 min
Question 2	Provisions, reimbursements	± 15 min
Question 3	Contingent liabilities	± 12 min
Question 4	Restructuring provision	± 15 min
Question 5	Onerous contracts, discounting, disclosure	± 40 min

QUESTION 1

The Mighty Mouse Trap Company Limited has just started with the export of mouse traps to the USA. The advertising slogan for the mouse traps is: "*A girl's best friend*". The following claims have been instituted against the company during the year:

(a) Mr. G Washington lost his thumb while he was handling a mouse trap with an extraordinarily strong spring. He is claiming R5 000 in respect of medical and other costs. According to the company's legal representatives there is a good chance that the claim will succeed. The company intends settling the claim without appeal and unnecessary negative publicity. The exact amount to be paid is uncertain, but should be in the region of R5 000.

(b) The Californian Women's Liberation Movement is claiming R10 000 from the company because the advertising slogan allegedly compromises women's dignity. The company's legal representatives are of the opinion that the success of the claim will depend on the judge which presides over the case. They however estimate that there is a 70% probability that the claim will be thrown out and a 30% probability that it will succeed.

(c) Mr. A Lincoln claims R100 000 on the basis that his fear of mice is widely known and that the company's advertising slogan makes him appear feminine in the eyes of the general public. The company's legal representatives are of the opinion that the chance of the claim succeeding, is remote.

REQUIRED:

Discuss how these matters should be accounted for.

QUESTION 2

Boss Limited specialises in the design and manufacture of an exclusive sports car. During the current financial year, 90 (ninety) sports cars have been completed and sold.

During the testing of the sports car, with the intention of effecting improvements, a serious defect was found in the steering mechanism of the sports car.

All 90 customers were informed in a letter of the defect and were required to bring the cars back to have the defect repaired at no charge. Customers have indicated that this arrangement is acceptable and that no further steps need to be taken. The estimated cost related to this will amount to R900 000.

The manufacturer of the steering mechanism, a listed company with sufficient funds, have accepted responsibility for the defect, and has undertaken to reimburse Boss Limited for all costs which it may incur in this regard.

REQUIRED:

Discuss how Boss Limited should account for the matter in its annual financial statements.

QUESTION 3

You are the auditor of a diversified group of companies with several branches in trade and industry. All subsidiaries are wholly owned. The group annual financial statements for the year ending 31 December 20X7 were approved for issue on 24 March 20X8. In the course of the audit you established the following:

i. One of the companies in the group exhibits at the Rand Easter Show on an annual basis. This company showed a profit of R250 000 from its 20X7 show exhibition activities. The company will once again exhibit at the 20X8 Show, but the rent paid will be substantially more as a bigger exhibition stall will be used. The board of directors are of the opinion that provision will have to be made for operating losses that will be suffered in respect of show activities for 20X8. A provision of R250 000 was made in this regard. (2)

ii. A claim of R1,2 million was made against one of the companies in the group due to alleged breaching of patent rights. The board of directors is convinced that the claim is unsubstantiated, but requested the legal advisors of the company to investigate the possibility that the claim may succeed. At this stage a preliminary decision was taken not to report on the matter. Your audit investigation could not shed any additional light on the probability of the claim being successful. (6)

REQUIRED:

Judge the acceptability of the different proposals in the light of International Financial Reporting Standards.

(QE 1988 adapted)

QUESTION 4

Cio Limited has decided to restructure its management due to new labour legislation forcing companies to ensure that their management are representative of the demografic composition of the country.

The following information is at your disposal:

- the company entered into negotiations with employee groups on 15 February 20X2, which were finalised by 30 June 20X2;
- the final restructuring plan, drafted by the managing director, was completed on 12 August 20X2;
- the restructuring plan was approved at the board meeting held on 17 August 20X2;
- the restructuring decision was announced to all employees as well as in the Business Day on 20 August 20X2;
- implementation of the plan commenced on 1 September 20X2.

You are aware of the following costs that are to be incurred:

- retrenchment packages to be paid to managers that will not be retained;
- training costs for certain managers that are to be retained, be that need to brush up on certain skills;
- contract cancellation costs.

Because Cio Limited's staff complement will decrease, the company intends selling all the office furniture and equipment as well as company cars used by the managers who are retrenched. A suitable buyer has already been identified. Costs will be incurred in respect of dismantling these assets and delivering them to the purchaser.

REQUIRED:

a. Discuss at what stage the restructuring costs can be recognised.

b. Discuss what amounts are to be included in the liability.

c. Discuss when the sale of assets ought to be recognised.

QUESTION 5

Jefco Ltd is a company listed on the JSE Limited. Jefco Ltd is involved in retailing, manufacturing as well as construction.

The following information relates to Jefco Ltd for the financial year ended 31 December 20X2:

1. For a number of years Jefco Ltd has had its flagship retail outlet in the CBD (central business district) of Pretoria. Due to business and consumers relocating to the eastern suburbs the turnover and profitability has declined over the past two years.

   For the year ended 31 December 20X2 the gross profit of the retail outlet amounted to R2 976 000, considerably lower than budgeted. For the same year the monthly rental of the premises was R247 500. The lease contract escalates at 7% per annum on 1 January each year and expires on 30 June 20X5. Due to penalty clauses in the lease contract, management decided at 31 December 20X2 to continue with the business until the end of the lease term, rather than to cancel the contract.

   The gross profit is earned evenly throughout the year and at 31 December 20X2 it was established that the gross profit will amount to R2 952 000 per annum in the foreseeable future. All receipts and payments are received/paid monthly in arrears.

2. On 1 February 20X2 the government awarded Jefco Ltd a contract to rebuild two bridges that were destroyed in recent floods in the Limpopo Province.

   The project will be completed at 31 July 20X4. The work involves the diverting of the road at both bridges, by building temporary bypass roads, as well as the damming and diverting of the river at one of the bridges. At 30 May 20X2 the bypass roads and damming of the river were completed and construction on the bridges commenced.

   The contract stipulates that the damming and diverting of the river must be restored at completion of the contract. Nothing is required or stipulated in the contract regarding the temporary roads. However, Jefco Ltd has a policy to restore the environment at each site where they have completed a project. This policy that is generally known, builds their image and promotes public relations.
   The estimated cost to restore the river and damming is R2 200 000 and to restore the bypass roads is R1 850 000.

3. The audit firm started with the audit of Jefco Ltd on 2 February 20X3. The firm estimated that the audit fee for the 20X2 year will amount to R80 000. No provision has been made yet.

Additional information

- Jefco Ltd considers a pre-tax discount rate of 9% p.a. (compounded monthly) to be the current rate applicable in the market.

- The current normal tax rate is 30%. Ignore any other tax, unless specified in the information given.

REQUIRED

(a) For the information in notes 1 to 3 above, journalise the accounting entries necessary for the year ended 31 December 20X2, giving brief reasons for your answers.

(b) Disclose all notes for the year ended 31 December 20X2, relating to profit before taxation, as well as provisions in accordance with the requirements of International Financial Reporting Standards.

Round off all amounts to the nearest Rand.