

Accounting for future events: Post balance sheet events

- **Information received after the year end**
 - **two types of events: adjusting & non-adjusting**
- **adjusting events**
 - **give more information about the position at year end**
 - **include in the amounts in the financial statements, eg: insolvency of a debtor, write off the amount**
- **non-adjusting events**
 - **clearly fall in the next period, but will affect investors' view of the company**
 - **disclose in a note, with financial effect**
 - **eg: proposed merger, reorganisation**
- **distinguishing between adjusting & non-adjusting**
 - **company sells part of its stock at loss after the year end**
 - **when did the fall in value occur?**
 - **unadjusting must be clearly in the next period**

Accounting for future events: Provisions

- **Make a provision only when it is a liability**
- **Liability is:**
 - obligation to transfer benefits as a result of a past transaction
- **Make provision when**
 - present (*more likely than not*) obligation (*legal or constructive*), and
 - probable (*more likely than not*) that benefits will be transferred
- **Obligation**
 - legal
 - constructive (commercial)
 - involves reputation
 - expectations of 3rd parties
 - company has no discretion, is obliged
 - management intent is not enough

- **amount is best estimate, not worst outcome**
- **example**
 - company sells goods under warranty
 - estimates that costs are
 - £1m if all contain minor defects
 - £4m if all contain major defects
 - estimates probabilities
 - 75% will contain no defects
 - 20% will have minor defects
 - 5% will have major defects
 - best estimate is
 - $0.75 * £0m + 0.20 * £1m + 0.05 * £4m =$
 - £400,000

- How provisions should work

Balance sheet at 20X1

<u>Assets</u>		<u>Liabilities</u>	
Bank		Provision	+10
		Reserves	
		P&L	-10

Balance sheet at 20X2

<u>Assets</u>		<u>Liabilities</u>	
Bank		Provision	10 +10
		Reserves	
•		P&L	-10

Balance sheet at 20X3

<u>Assets</u>		<u>Liabilities</u>	
Bank	-20	Provision	20-20
		Reserves	
		P&L	

- How provisions can be misused

Balance sheet at 20X1

<u>Assets</u>		<u>Liabilities</u>	
Bank		Provision	+10
		Reserves	
		P&L	-10

Balance sheet at 20X2

<u>Assets</u>		<u>Liabilities</u>	
Bank		Provision	10 +10
		Reserves	
		P&L	-10

Balance sheet at 20X3

<u>Assets</u>		<u>Liabilities</u>	
Bank	-18	Provision	20-18-2
		Reserves	
		P&L unused provision	+2

- **provisions can be a method of transferring profits now to profits in the future**
- **strict rules now are the price paid for misuse of provisions in the past**
- **types of transaction caught**
 - **reorganisation costs** unless there is an obligation (eg agreed a contract)
 - previously, charged as soon as the need for the expenditure was identified
 - **self insurance**, companies would set up provisions in anticipation of future losses. But not now as there is no obligation, the loss has not yet occurred. Examples include: oil spills, machine breakdowns, fire and theft self insurance
 - **acquisitions**, provisions for future losses. When acquiring another company, set up provision against which to charge future losses. Accentuates growth of profit, post acquisition.
- **the P&L is now more volatile as a result of this**

Accounting for future events: Contingencies

- **no critical event has taken place, yet**
 - contrast with post balance sheet events
- **not include accounting uncertainties**
 - this is measurement uncertainty
 - expected life of fixed assets
 - amount of bad debts
- **what distinguishes from ordinary uncertainty?**
 - event uncertainty
 - the event that will create the liability is uncertain
 - don't know if going to have a liability at all
 - zero is a possible outcome
 - eg: litigation, when tax rules are unclear

- **Contingent assets**
 - probability of flow of benefits decides the treatment
- **Contingent liabilities**
- **need to consider**
 - the probability of obligation
 - the probability of the flow of benefits
- **Assets require higher likelihood than liabilities**

Contingent assets

Inflow of benefits

Treatment

Virtually certain	Not contingent, recognise
Probable	Contingent, but note in accounts
Remote	ignore

Contingent liabilities

Obligation

Transfer of benefits

Treatment

Present	probable	Recognise, not contingent
Present	Not probable, but not remote	Contingent, but note in accounts
Possible	Not remote	Contingent, but note in accounts
Possible	Remote	ignore

Present obligation	More likely than not (>50%)
Possible obligation	Less than or just as likely as not (<=50%)
Probable transfer of benefits	More likely than not (>50%)

Amer, Hackenbrack & Nelson, Auditing, 13/1, Spring 1994

- 49 audit managers from the same firm
- Find variety of interpretations for standard probability phrases

<u>Phrase</u>	<u>Median (%)</u>	<u>Inter Quartile range(%)</u>
“Impossible”	0	5
“Doubtful”	15	10
“possible”	50	5
“Reasonably likely”	70	15
“Likely”	75	19