IAS 37 QUESTION

Q-1 A Singapore-based shipping company lost an entire shipload of cargo valued at $5 million on a voyage to Australia. It is, however, covered by an insurance policy. According to the report of the surveyor the amount is collectible, subject to the deductible clause (i.e., 10% of the claim) in the insurance policy. Before year-end, the shipping company received a letter from the insurance company that a check was in the mail for 90% of the claim.

The international freight forwarding company that entrusted the shipping company with the delivery of the cargo overseas has filed a lawsuit for $5 million, claiming the value of the cargo that was lost on high seas, and also consequential damages of $2 million resulting from the delay. According to the legal counsel of the shipping company, it is probable that the shipping company would have to pay the $5 million, but it is a remote possibility that it would have to pay the additional $2 million claimed by the international freight forwarding company, since this loss was specifically excluded in the freight forwarding contract

Required

What provision or disclosure would the shipping company need to make at year-end?

Q-2 The board of directors of ABC Inc. at their meeting held on December 15, 20X1, decided to close down the entity‟s international branches and shift its international operations and consolidate them with its domestic operations. A detailed formal plan for winding up the international operations was also formalized and agreed by the board of directors in that meeting. Letters were sent out to customers, suppliers, and workers soon thereafter. Meetings were called to discuss the features of the formal plan to wind up international operations, and representatives of all interested parties were presenting those meetings.

Required

Do the actions of the board of directors create a constructive obligation that needs a provision for restructuring?

Q-3 XYZ Inc. is getting ready to move its factory from its existing location to a new industrial free zone specially created by the government for manufacturers. To avail itself of the preferential licensing offered by the local governmental authorities as a reward for moving into the free trade zone and the savings in costs that would ensue (since there are no duties or taxes in the free trade zone), XYZ Inc. has to move into the new location before the end of the year. The lease on its present location is non-cancelable and is for another two years from year-end. The obligation under the lease is the annual rent of $100,000.

Required

Advise XYZ Inc. what amount, if any, it needs to provide at year-end toward this lease obligation.

IAS 37 - SOLUTION

Q-1 The shipping company would need to recognize a contingent asset of $4.5 million (the amount that is virtually certain of collection). Also it would need to make a provision for $5 million toward the claim of the international freight forwarding company. Because the probability of the claim of $2 million is remote, no provision or disclosure would be needed for that.

Q-2 The lease agreement is an executory onerous contract because after moving to the new location, XYZ Inc. would derive no economic benefits from the existing factory building but would still need to pay rent under the agreement since the lease is non-cancelable. Thus the unavoidable costs exceed the benefits expected under the lease contract.
Based on the annual lease obligation under the lease agreement, the total amount needed to be provided at year-end is the present value of the total commitment under the lease = PV of **[$100,000 × 2 (years)].**

Q-3 The expected value of the provision for warranty needed at year-end is:
(60% × 0) + (25% × $10,000) + (15% × $30,000) = $7,000.