

42.1 A drill to practise setting up and adjusting provisions for expected liabilities

REQUIRED: for each set of data below, show a P&L Account extract for each of the relevant years, and an account for the relevant provision with the balance at the end of each year.

Business 1

YEAR 1: a business dismisses an employee for (alleged) gross misconduct. The employee sues the business for wrongful dismissal. The business is advised by its lawyers that it may be found liable for damages in the sum of £200 000 if the case comes to court.

YEAR 2: the case remains undecided.

YEAR 3: the case remains undecided, but lawyers advise the firm that the maximum liability it would face is probably not more than £150 000.

P&L 1		Provision	
			<i>P&L 1</i>
<i>new provision</i>	200 000		<i>new provision</i> 200 000
			<i>= balance at end of YR1</i>
P&L 2			
		<i>c/f</i> 200 000	
		200 000	200 000
			<i>balance at end of YR2</i> 200 000
P&L 3			
		<i>decrease in YR 3</i> 50 000	
		<i>c/f</i> 150 000	
		200 000	200 000
	<i>decrease in provision</i> 50 000		<i>balance at end of YR3</i> 150 000

Business 2

YEAR 1: an engineering firm builds a bridge which falls down. The firm is sued for damages and expects to lose £200 000.

YEAR 2: lawyers advise the firm that it will probably be found liable for damages of £250 000.

YEAR 3: the case remains undecided.

P&L 1		Provision	
new provision	200 000		P&L 1 new provision 200 000
			= balance at end of YR1
increase in provision	50 000		increase in YR 2 50 000
		c/f 250 000	
		250 000	250 000
			balance at end of YR2 250 000
		c/f 250 000	
		250 000	250 000
			balance at end of YR3 250 000

Business 3

YEAR 1: a customer visiting the premises of a business falls down, breaks her leg, and sues the business for £15 000. The business denies liability, and at the end of the year the case is not yet decided, but the business is advised by its lawyer that it is likely to be found liable for damages in the sum of £12 000.

YEAR 2: the case remains undecided.

YEAR 3: it emerges that the customer ignored repeated safety warnings and forced the lock on a door in order to enter the area where she fell down. The case is therefore dropped.

P&L 1	
new provision	12 000
P&L 2	
P&L 3	
release of provision	12 000

Provision	
	P&L 1 new provision = balance at end of YR1 12 000
c/f	12 000
	12 000
	balance at end of YR2 12 000
decrease in YR 3	12 000
	12 000

Business 4

YEAR 1: a business decides to close a branch of its operations. Closure will actually take place in Year 2. It is estimated that the costs of closure (mainly redundancy payments) will be £400 000.

YEAR 2: revival of demand in the area means that the firm abandons its plans to close the branch.

The diagram illustrates the flow of a provision. On the left, a T-account for 'P&L 1' shows a credit entry of 'new provision 400 000'. A dashed vertical line connects this entry to a credit entry of 'release of provision 400 000' in the 'P&L 2' T-account below it. To the right, a T-account for 'Provision' shows a credit entry of 'P&L 1 new provision = balance at end of YR1 400 000' and a debit entry of 'release in YR 2 400 000'. The final balance of 400 000 is shown on the credit side of the Provision account.