Provisions for warranties

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Introduction

A company has commenced issuing of warranty certificates at the beginning of last year on their sales. Intention was to increase their customer base. They have issued ten year warranty for the sofa at the date of the invoice. The warranty certificate indicated followings three facts. Firstly that they have a current obligation as a result of past event. This also creates a probability of outflow of future economic benefit from company and this probable out flow can be measured reliably. But management of the company has not recognized provision for warranty issued. According to LKAS 37, company should recognize and disclosure provision in their financial statement if such warranty meets the recognition criteria mentioned in LKAS 37.

Discussion of the issue

A provision can be defined as a liability of uncertain of timing or amount. The company should recognize Provision when an only if recognition criteria is met. As per the case mentioned in above, the company should made provision because the warranty meets the required criteria to made provision under LKAS 37. The recording of provision affects both statements of financial position as well as an appropriate expense account (Statement of Comprehensive Income). Even though provision has effect taxable income of the company and accounting for provision may adversely affect to profitability of the company. Provision is consider as a liability of the company and increasing provision means increase in liability which is indirectly affect to the solvency of the company as well as it may indirectly affect to profitability ratio, expenses ratio, etc.

Conclusions and Recommendations

According to the LKAS 37 provision shall be recognized when;

a.) An entity has a present obligation (legal or constructive) as a result of a past event;

b.) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and

c.) A reliable estimate can be made of the amount of the obligation

If these conditions are not met, no provisions shall be recognized

Present obligation means, in rare cases it is not clear whether a present obligation is. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exits at the end of the reporting period

As per.the issue mentioned in above, the management should need to identify provision because issued warranty meet the provision recognition criteria given under LKAS 37. Those criteria are summarized as follows in an applicable way to the company

- Present obligation as a result of a past obligation event

The company sold sofa with a ten year warranty which is obligation event gives rise to a legal obligation.

- An outflow of resources embodying economic benefits in settlement.

  There is a Probability that some outflows of resources require to settle the obligation come under warranty issued.

- A reliable estimate can be made of the amount of the obligation

  Company can reliable estimate the amount of the obligation based on the past experience.

The company should recognize for the best estimate of the cost of repair sofa which is satisfied the condition warranty under the warranty product sold before the end of the reporting period.