IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

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Examiner: Formation 2 Financial Accounting

Background

Before the introduction of IAS 37, there was little meaningful guidance on when a provision must be made and therefore it led to potential accounting abuse. This lack of guidance caused problems where some companies could make and then subsequently release provisions in order to smooth profits. It was particularly used by new management in companies whereby they would set aside large provisions for restructuring in their first year thereby reducing profits and then release any unneeded provisions in later years thereby increasing profits. Users of financial statements therefore found it difficult to determine the real underlying profits in companies due to the charging or releasing of provisions.

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

Definition

A provision is a liability of uncertain timing or amount. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Recognition

The recognition criteria are the same as those in the framework for all liabilities.

A provision should be recognised 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 economic resources** will be required to settle the obligation, and
c) A **reliable estimate** can be made of the amount of the obligation.

If any one of these conditions is not met, no provision may be recognised.

Provisions are reviewed each year and adjusted to reflect current best estimate, if it is no longer probable that an outflow of resources embodying economic benefits will be required, the provision is reversed.

Present obligations and obligating events
A past event which leads to a present obligation is called an obligating event. An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

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

Legal and constructive obligations
An obligation can either be legal or constructive.

A legal obligation is one that derives from a contract, legislation or any other operation of law.

A constructive obligation is an obligation that derives from the actions of an entity where:

a) From an established pattern of past practice, published policies or a specific statement the entity has indicated to other parties that it will accept certain responsibilities; and
b) As a result the entity has created a valid expectation in other parties that it will discharge those responsibilities.

An intention to make a payment is not enough on its own to justify a provision. There must be an actual obligation to make a payment.

This is important, for example, in the accounting for repairs or refurbishments known to be required in future. Let us assume that a building's lease agreement includes the requirement that the owner has to repaint the exterior every three years and this is estimated at a cost of €30,000. The company owing (the lessee) would prefer, for profit smoothing purposes, to allocate the cost equally over the three years rather than recognise all of the cost in the third year. This would require a provision of €30,000 to have been created, at €10,000 p.a., over three years. At the end of year three the provision would have been reduced affected by €10,000 p.a. over each of the three years.

IAS 37 does not permit this approach, because there is no obligation to incur this cost until the three years have elapsed. In the first two years, this would be future obligation which could be avoided if for example the building was sold before the third year. IAS 37 requires the full cost to be recognised in the third year and not equally over the three years.

Example 1
A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Should a provision be made at the year-end?

Solution
The policy is well known and creates a valid expectation. There is a constructive obligation. It is probable some refunds will be made and these can be measured using expected values. Therefore, a provision is required.

Example 2
Under new legislation, an entity is required to install smoking rooms to its factories by 30 December 20X7. The entity has not installed the smoking rooms.

Required: **Should a provision be recognised at the end of the reporting period?**
a) 31 December 20X6
b) 31 December 20X7

Solution

a) At 31 December 20X6, there is no obligation as there is no obligating event either for the costs of installing and erecting the smoking rooms (the rooms have not yet been fitted) or for fines under the legislation. Therefore, no provision is recognised.

b) At 31 December 20X7, there is still no obligation for the costs of installing the smoking rooms as no obligating event has occurred (the installation of the smoking rooms).
However, an obligation may arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

A provision should be made for the best estimate of any fines or penalties that are more likely than not to be imposed under the legislation.

Measurement
The amount recognised as a provision is the best estimate of the expenditure required to settle the obligation at the end of the reporting period.
Provisions are **discounted** where the effect of the time value of money is material.

The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the statement of financial position.

Uncertainties
Where a single obligation is being measured i.e. the provision relates to one event

- The individual most likely outcome may be the best evidence of the liability.

Where the provision involved a large population of items

- Use expected values taking into account the probability of all expected outcomes.

Example 3
An entity sells goods with a warranty covering customers for the cost of repairs of any defects that are discovered within the first two months after purchase. Past experience suggests that 80% of the goods sold will have no defects, 15% will have minor defects and 5% will have major defects. If minor defects were detected in all products sold the cost of repairs would be €30,000; if major defects were detected in all products sold, the cost would be €150,000.

Required: **What amount of provision should be made?**

Solution
The expected value of the cost of repairs is €12,000 i.e. 15% x €30,000 + 5% x €150,000.

Example 4
An entity has to rectify a serious fault in a piece of equipment that it had sold to a customer. The individual most likely outcome is that the repair will succeed at the first attempt at a cost of €50,000, but there is a chance that a further attempt will be necessary, increasing the total cost to €80,000.

Required: What amount of provision should be made?

Solution
A provision for €50,000 is recognised.

This is because the best estimate of the liability is its most likely outcome, not the worst-case scenario.

Disclosure
For each class of provision, an entity must disclose;

a) A reconciliation showing;
    i. the carrying amount at the beginning and end of the period;
    ii. additional provisions made in the period, including increases to existing provisions;
    iii. amounts used (i.e. incurred and charged against the provisions) during the period;
    iv. amounts reversed unused during the period; and
    v. the increase during the period in the discounted amount existing from the passage of time and the effect of any change in the discount rate.
b) A brief description of the nature of the obligation and the expected timing of any resulting economic outflows.
c) An indication of the uncertainties about the amount or timing of those outflows. (Disclose also any assumptions about future events if applicable).
d) The amount of any expected reimbursement stating the amount of any asset that has been recognised for that expected reimbursement.

Contingent Liabilities

A contingent liability is either
a) a possible obligation arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity; or
b) a present obligation that arises from past events but is not recognised because
    i. It is not probable that an outflow of economic benefits will be required to settle the obligation; or
    ii. The amount of the obligation cannot be measured with sufficient reliability.

Recognition
A contingent liability is not **recognised**. A contingent liability is disclosed unless the possibility of an outflow of economic benefits is remote i.e. generally less than 5% chance.

Disclosure
For each class of contingent liability, an entity must disclose at the end of the reporting period, all of the following:
a) the nature of the contingent liability
b) an estimate of its financial effect
c) an indication of the uncertainties relating to the amount or timing of any outflow
d) the possibility of any reimbursement.

Example 5

1. X Limited. issued a one year guarantee for on equipment that it sells to its customer. At the company's year end, the company is being sued by one of its customers for refusing to repair equipment within the guarantee period. X Limited is of the view that the fault is not covered by the guarantee as it believes that it has arisen because the customer incorrectly followed the instructions on using the equipment,

   X Limited's company lawyer has advised that it is more likely than not that they will be found liable. This would result in the company being forced to repair the equipment plus pay legal expenses amounting to approximately €20,000.

2. The company also manufactures another line of equipment which it sells to wholesalers. The company sold 2,000 items of this type this year, which also has a one year guarantee if the equipment fails. Based on past experience, 10% of items sold are returned for repair. In each case, 40% of the items returned are able to be repaired at a cost of €100, while the remaining 60% need significant repair at a cost of €300.

Required: Discuss the accounting treatment of the above situations

Solution

1. At the end of the reporting period, X Limited disputes liability (and therefore, whether a present obligation exists). However, given that more likely than not it will be found guilty, based on the lawyers advice, a present obligation is assumed to exist. Given that a single obligation is being measured, a provision is made for the outflow of the most likely outcome i.e. a provision is recognised for €20,000.

2. A present obligation exists at the end of the reporting period based on historical evidence of items being repaired under the guarantee agreement.
   Here, a large population of items is involved. A provision is therefore made for the expected value of the outflow:

2,000 x 10% x 40% x €100	€ 8,000
2,000 x 10% x 60% x €300	<u>€36,000</u>
	<u>€44,000</u>

Example 6

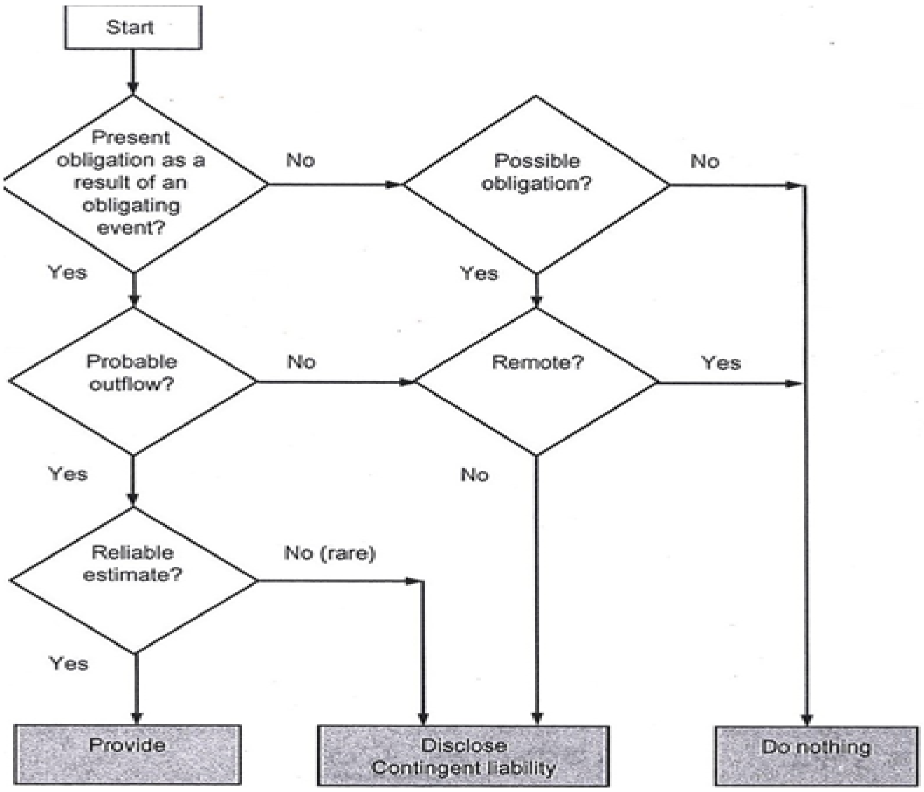
During the year to 31 December 20X5, a customer started legal proceedings against a company, claiming that one of the food products that it manufactures had caused several members of his family to become seriously ill. The company's lawyers have advised that this action will probably not succeed.

Required: Should the company disclose this in its financial statements?

Solution

Legal advice is that the claim is unlikely to succeed. It is unlikely that the company has a present obligation to compensate the customer and therefore no provision should be recognised. There is, however, a contingent liability. Unless the possibility of a transfer of economic benefits is remote, the financial statements should include a brief description to disclose the nature of the contingent liability, an estimate of its financial effect and an indication of the uncertainties relating to the amount or timing of any outflow.

Decision Tree in relation to Provisions and Contingent Liabilities



Contingent Assets

A contingent asset is a possible asset arising from past events whose existence will only be confirmed by the occurrence of one or more uncertain future events not wholly within the control of the entity.

Recognition
A contingent asset is not recognised because it could result in the recognition of profits that may never be realised. However, where the realisation of profit is virtually certain, then the related asset is not a contingent asset and recognition is appropriate.

A contingent asset is disclosed where an inflow of economic benefits is probable i.e. >50%.

Disclosure
The following must be disclosed:

a) A brief description of the nature of the contingent asset at the end of the reporting period
b) Where practicable, an estimate of the financial effect.

Example 7
A common example of contingencies arises in connection with legal action. For example, if Company A sues Company B because it believes that it has incurred losses as a result of Company B's faulty products, then Company B may be liable for damages. Whether or not the damages will actually be paid depends on the outcome of the case.

Solution
Until there is some degree of certainty known in relation to the court case, Company B has a contingent liability and Company A has a contingent asset.

Warranty Provisions
A warranty is often given in manufacturing and retailing businesses. There is either a legal or constructive obligation to make good or replace faulty products.

A provision is required at the time of the sale rather than the time of the repair/replacement as the making of the sale is the past event which gives rise to an obligation. This requires the seller to analyse past experience so that they can estimate:

- How many claims will be made;
- How much each repair will cost

The provision set up at the time of sale:
- Is the number of repairs expected in the future multiplied by the expected cost of each repair.
- This provisions should be reviewed at the end of each accounting period in the light of further experience.

Future Operating Losses/Future Repairs
Provisions shall not be recognised for future operating losses as they don't meet the definition of a liability and they arise in the future and could potentially be avoided and therefore, no obligation would exist.

Onerous Contracts
An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

Unavoidable costs of meeting an obligation are the lower of:

Costs of fulfilling the contract

Penalties from failure to fulfil the contract

Example 8
A Limited has a contract to buy 3,000 phones per month for €50 per phone. Usually the company can sell each phone for €80 but in late November due to cheaper manufacturing techniques and technologies the market price falls to €40. The company is considering ceasing selling phones as it thinks that the market may not improve. If the company decides to cancel the phone purchase contract without two months' notice then it must pay a cancellation penalty of €20,000 for each of the next two months.

Required
a) Is there a present obligation at the period end 31 November 20X5?
b) What will appear in respect of the contract in the company's financial statements for the period ending 31 November 20X5?

Solution

Unavoidable costs of meeting an obligation are the lower of:

Costs of fulfilling the contract

Penalties from failure to fulfil the contract

Honour Contract

	€
Revenue (3,000 x €40 x 2 mths)	240,000
Costs (3,000 x €50 x 2 months)	300,000
Loss	(60,000)

Cancel Contract

	€
Penalties (€20,000 x 2 months =	€40,000)

Therefore, the unavoidable loss is €40,000.

This will be shown as a provision in the SOFP and an expense in the SOPL.

Disclosure notes will give a brief description of the circumstances and of the obligation as well as an indication of the uncertainties about the timing of payments, amounts and assumptions concerning the market.

Onerous Leases
An onerous lease is an onerous contract. If, for example, a leased premises has become surplus to requirements but the lessees cannot find anyone to sublet the premises to, the lessees will still have to make the regular lease payments, without being able to use the premises.

The signing of the lease is the past event giving rise to the obligation to make the lease payments and those payments, discounted if the effect is material, will be the measure of the excess of cost over the benefits.

A provision for this net cost should be recognised as an expense in the SOPL in the period when the lease becomes onerous. In subsequent periods, this provision will be increased by the unwinding of the discount (recognised as a finance charge) and reduced by the lease payments made.

Example 9
A company has ten years left to run on the lease of a property that is currently unoccupied. The present value of the future rentals at the reporting date is €30,000.

Required: What is the accounting treatment?

Solution
A provision of €30,000 would be required in respect of this onerous contract.

Environmental Provisions
A provision will be made for future environmental costs if there is either a legal or constructive obligation to carry out the work

This will be discounted to present value at a pre-tax market rate.

Restructuring Provisions
A restructuring is a programme that is planned and controlled by management and materially changes either:

a) The scope of a business undertaken by an entity, or
b) The manner in which that business is conducted.

A provision may only be made if:

- A detailed, formal and approved plan exists, and
- The plan has been announced to those affected.

The provision should:

- Include direct expenditure arising from restructuring
- Exclude costs associated with ongoing activities.

Any provision may only be made if a present obligation exists.

In the context of a restructuring, a detailed, formal and approved plan must exist but this is not enough, because management may change its mind. A provision should only be made if the plan has also been announced to those affected. This creates a constructive obligation, because management is now very unlikely to change its mind. The restructuring provisions may only include direct expenditure arising from the restructuring which is both necessarily entailed by the restructuring and not associated with the ongoing activities of the entity. It should therefore, include costs such as redundancies and write-downs on PPE. Costs associated with retraining or relocating staff, marketing or investment in new systems and distribution networks may not be included in the provisions because they relate to the future conduct of the business.