Accounting for Provisions and Contingencies

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This article is designed to assist students in preparing for questions on the topics of Provisions, Contingent Liabilities and Contingent Assets on the P1 Corporate Reporting paper. It is also likely to be of benefit to students of P2 Advanced Corporate Reporting and F2 Financial Accounting.

Introduction

This topic is covered by the IASB standard IAS 37 *Accounting for Provisions, Contingent Liabilities and Contingent Assets*. 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.

In simple terms, IAS 37 seeks to ensure that provisions are recognised when appropriate to do so, and are not recognised when inappropriate. Part of the rationale behind IAS 37 was the prevention of income smoothing that may result from the inappropriate use of provisions.

Definition of a provision

A provision is a liability of uncertain timing or amount.

A liability is defined in the *Conceptual Framework* (para 4.4 (b)) as "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."

A provision must meet the above definition. The word "expected" clearly allows for uncertainty. The timing and/or the amount of the outflow of economic benefit may be uncertain. Hence an estimate of these must be made when recording a provision in the books.

IAS 37 sets out strict guidance regarding when a provision should be recognised. This should be read both ways. It is equally strict in implying when a provision must not be recognised. There was a tendency for preparers to abuse the prudence concept and over recognise provisions based on the possibility of outflows of economic benefits rather than the obligation to incur such outflows. This would have created a buffer of provisions that could be reversed by crediting profit or loss when a profit boost was deemed desirable.

There are three conditions laid down by IAS 37, all of which must be met if a provision is to be recognised. These are explained as follows:

Recognition and measurement

A provision should be recognised when, and only when:

(a) An entity has a present obligation (legal or constructive) as a result of a past event;
(b) It is probable (i.e. more likely than not) 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. The Standard notes that it is only in extremely rare cases that a reliable estimate will not be possible.

These are expanded on below.

1. Present obligation

Assessing whether or not there is a present obligation can sometimes be problematic. The following points should help:

- There must be a present obligation at the reporting date. This means there must be no reasonable way of avoiding settlement. Just because a payment would be in the entity's interest is not by itself an obligation on the entity to make the payment. This excludes costs like future maintenance from being provided for. There are alternatives to incurring maintenance costs, including selling the asset, upgrading it, and letting it deteriorate.
- This obligation must be as a result of a past event, called an obligating event. If the obligation is dependent on a future event, it is NOT an obligation. Hence, a cost for environmental damage expected to be caused in the future may not be provided for.
- If a contract has obligations remaining to be fulfilled on both sides, then it is an executory contract. Provisions may not be made for these contracts until one side performs their obligations. An example is an employment contract agreed for three years at a salary of €100,000 per year. At inception, both parties have obligations. However, no provision is recognised for the cost of this contract to the entity until the counterparty has performed its obligation. In simple terms, we don't have any obligation to pay salary until the worker has performed service. Hence no provision will be made for the salary until the worker earns it, by doing the work agreed in the contract.
- A constructive obligation is one that is not legally enforceable but is an obligation due to the entity's publicly communicated intentions and past practice. For a constructive obligation to qualify as a present obligation there must be a valid expectation that the entity will discharge the obligation and the entity must intend to discharge it. A good example is an unconditional money back guarantee.
- 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 account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

2. Probable outflow

An outflow of economic benefits is deemed to be probable if it is more likely than not to occur. This generally means more than 50% likely. Just because an outflow is probable does not automatically mean there is an obligation. There must be an obligating event also.

3. Measurement of amount

The amount recognised as a provision will be the best estimate, at the reporting date, of the expenditure required to settle the present obligation. 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 reporting date or to transfer it to a third party at that time.

Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. A good example of this is a warranty provision. Individually, each item may have a small chance of needing warranty repair. However, across all the items sold there is likely to be a high probability that warranty cost will be incurred.

Where a single obligation is being measured, the individual most likely outcome is used be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. For example, if the entity is considering the outcome of a binary event (two possible outcomes), such as a court case, then the most likely outcome is used to measure the expected outflow.

If the time value of money is material, provisions should be discounted to present value. As time passes, increases in any provision so discounted will result from the unwinding of the discount. This increase should be recognised in profit or loss (finance costs).

If estimates of amounts change, the most recent estimate must be included in the financial statements. Judgment must be made at each reporting date. Any adjustments required are taken to profit or loss.

If events after the reporting date provide information that sheds more light on uncertainties existing on the reporting date, these should be taken into consideration in accordance with IAS 10 *Events after the Reporting Date.*

Contingent liabilities

A contingent liability is:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-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 resources embodying economic benefits will be required to settle the obligation; or

  (ii) The amount of the obligation cannot be measured with sufficient reliability.

The above guidance is saying that if any one of the three conditions required for recognition of a provision is not met, but the item is a possible obligation at the reporting date, then the item is a contingent liability. An entity should not recognise a contingent liability in the financial statements. An entity should disclose a contingent liability in the notes, unless the possibility of an outflow of resources embodying economic benefits is remote, in which case it should be ignored.

Contingent assets

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

An entity shall not recognise a contingent asset. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Disclosure

Disclosure is required of the following for each class of provision carried in the books:

- A description of the nature of the obligation and its expected timing;
- A description of the major uncertainties and any assumptions made;
- The amount of any expected reimbursement;
- The carrying amount at the beginning and end of the period;
- Additional provisions made in the period;
- Amounts of the provision used during the period;
- Any amounts reversed (unused) during the period;
- Any increase recognised due to the unwinding of any discount as time passes;
- Any changes resulting from any change in the discount rate.

Disclosure is required of the following for each class of contingent liability disclosed:

- A description of the nature of the contingent liability;
- An estimate of its financial effect;
- An indication of the uncertainties regarding its timing or amount;
- The possibility of reimbursement.

Examples and application guidance

In each case below, explain the appropriate accounting treatment under IAS 37. Assume all amounts are material and that the financial year ends on 31 December 2016.

1. Jericho plc supplies hairdryers to the European market with a 12 month warranty against faults. Past experience has shown that one hairdryer in every fifty units sold will have major faults requiring complete replacement, at a cost of €65. Additionally, three in fifty units sold will have minor faults necessitating repairs costing €18. During 2016, 20,000 hairdryers were sold.

Solution

The existence of a promise to repair defective goods is a present obligation caused by a past event (the sale of the hairdryers). There is a probable outflow of funds, and the amount can be reliably estimated by examining past experience.

Therefore a provision should be made for the expected cost of fulfilling the warranty promise.

Expected cost is (20,000 * 1/50 * €65) + (20,000 * 3/50 * 18) = €26,000 + 21,600 = €47,600.

Dr Profit or loss	€47,600	
Cr Provision for warranty costs		€47,600

If there had been an existing provision carried forward, this amount would be adjusted so the liability becomes equal to the estimated liability at the reporting date. Assume, in the above example, there was an existing provision of €40,000 in the books. The adjusting entry would now become:

Dr Profit or loss (47,600 – 40,000)	€7,600	
Cr Provision for warranty costs		€7,600

2. Gamma plc operates as an oil exploration company in several countries. It often causes environmental damage, but cleans up only when required to do so by law. In Murphyland, where the company has been contaminating the environment for several years, a law has been drafted requiring companies causing contamination to clean up. This law, which will apply retrospectively to past damage, has passed through all stages of parliament before Gamma's year end of 31 December 2016, but has not been signed into law yet as the president is on holidays. The president normally signs without question laws that are passed by parliament. It has been estimated that the costs of cleaning up the damage already caused will amount to €15m, and the damage expected to be caused in 2017 will cost €3.5m to repair if the law is passed.

Solution:
Here, damage of €15m has already been caused to the environment, so a past event has occurred causing the damage. The question is whether or not an outflow of economic benefit is probable. The law has passed through parliament and it appears that its signing is merely a formality. The law is retrospective therefore it is probable that the obligation will involve an outflow of funds. The amount can be reliably estimated. Therefore a provision should be recognised for €15m. No provision should be recognised for the damage expected to be caused in 2017 as no obligating event has yet occurred.

3. Hades Ltd operates offshore drilling rigs. As part of the terms of its drilling licence, Hades is required to dismantle the rigs and clean up any contamination at the end of the rigs' lives. During 2016 a new rig was constructed at a cost of €30m. The present value of the expected cost of dismantling this rig was estimated at €5m, and the present value of the cost of decontamination due to oil passing through the rig was estimated at €2.4m. At 31 December 2016 the rig was completed, but no oil had yet passed through it.

Solution:
At the reporting date the rig has been constructed, therefore a past event has occurred giving rise to an obligation to deconstruct the rig at a present value cost of €5m. This amount should be provided for as the obligation arises due to a past event, will lead to an outflow of funds, and this outflow can be estimated reliably.
No obligating event has yet occurred regarding the expected cost of cleaning up due to oil passing through the rig. Although Hades has an obligation to clean up such contamination, this is clearly contingent on oil actually passing through the rig. This hasn't happened, and therefore there is no past event giving rise to the obligation. Therefore no provision should be made for this part of the clean-up cost.

4. Kelly plc operates several clothing stores throughout Ireland. It has a policy of allowing refunds on all clothes returned within 4 weeks of purchase when accompanied by a valid receipt. There is no legal obligation to allow refunds, but it has maintained this policy for several years. Past experience has suggested that 10% of all clothes sold are returned for refund within the 4 weeks. During the last 4 weeks of the financial year ended 31 December 2016, sales totalling €780,000 were made at a gross margin of 30%. Returned items can be sold on at a discount of 50% of normal retail price.

Solution:
There in no legal obligation to allow refunds on returned items that are not faulty. However, past practice indicated that there is a constructive obligation to allow such refunds, as the company has clearly advertised this facility. Hence there is a valid expectation and the company intends to honour

this. As past experience suggests 10% of clothes sold will be returned, there is a probable outflow of resources, and this can be estimated reliably using past experience as a guide.
Therefore, provision should be made for the loss expected from the return of 10% of €780,000 worth of goods. The loss involves (1) loss of margin on sale plus (2) discount on subsequent sale if below cost. Together this is expected to amount to 50% of normal retail price, or €39,000. A provision should be made for this amount.

5. On 12 December 2016 Llama Ltd decided to close down a division. Expected costs of closure were estimated at €1.2m. No action was taken to communicate this to the affected parties until 23 January 2017.

Solution:
Provisions for restructuring may only be recognised when the entity has communicated to those affected their intention to restructure and formed a detailed plan for the restructuring. Neither of these seems to have happened at the reporting date, therefore no provision should be made. The subsequent communication is a non-adjusting event as the conditions were not met at the reporting date.

6. Legislation was passed on 30 September 2016 requiring the fitting of emissions filters to the factories of Melvil plc immediately. This law has not been complied with by the year end. The expected cost of fitting the filters is €375,000.

Solution:
No obligating event has yet taken place requiring a provision to be recognised. The law has been passed, but there is no past event triggering the obligation (such as the actual fitting of filters). Melvil has alternative options such as selling the factories, ceasing the activities requiring the filters, or securing alternative accommodation. Until an obligating event occurs no provision should be made.

7. Sam Ltd is being sued for €100,000 by a customer who slipped on a wet floor whilst at Sam's premises. Legal advice at the reporting date is that Sam is likely to win the case, as no negligence seems to be provable.

Solution:
A past event has occurred leading to a possible liability. The probability of outflow of economic benefit seems possible though not probable. Therefore disclosure of the contingent liability in the notes should be made.

8. A fire occurred at the premises of Tim Ltd during December 2010. Total damage was assessed at €350,000. It is a term of Tim's insurance policy that fire alarms be fitted to all premises. No fire alarms were fitted to the premises affected by the fire. It is hoped that Tim's insurers will cover this loss under the terms of the insurance policy. However the assessor has not yet provided his report or recommendations.

Solution:
Provision should be made for the costs of the fire by writing down the values of the assets affected. The potential claim from the insurance company is a contingent asset. The success of the claim is clearly not virtually certain therefore no recognition should be made of the amount. If success is considered to be probable, disclosure should be made in the notes. Otherwise it should be ignored.