

# PROVISIONS CONTINGENT LIABILITIES AND CONTINGENT ASSETS

## (IAS – 37)

### Objective

The objective of this IAS is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets.

### Scope

This IAS is applicable to all provisions, contingent liabilities and contingent assets except:

- a) those resulting from executory non-onerous contracts
- b) those covered by other IAS

### Definitions

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.

An **obligating event** is an event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation.

A **legal obligation** is an obligation that derives from:

- (a) a contract (through its explicit or implicit terms);
- (b) legislation; or
- (c) other operation of law.

A **constructive obligation** is an obligation that derives from an enterprise's action where:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

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 enterprise; or
- (b) a present obligation that arises from past events but is not recognized 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.

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 enterprise.

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.

A **restructuring** is a program that is planned and controlled by management, and materially changes either:

- (a) the scope of a business undertaken by an enterprise; or
- (b) the manner in which that business is conducted.

### **Provisions and other liabilities**

Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required settlement.

### **Provisions and contingent liabilities**

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term 'contingent' is used for liabilities and assets that are not recognized because their existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

### **Recognition**

#### **Provisions**

A 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 possible that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- c) A reliable estimate can be made of amount of the obligation.

If these conditions are not met, no provision shall be recognized.

#### **Present obligation**

In rare cases it is not clear whether there is a present obligation. In the 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.

#### **Past event**

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

- a) Where the settlement of the obligation can be enforced by law; or
- b) In the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

### **Contingent Liabilities**

An enterprise should not recognize a contingent liability.

- a) A contingent liability is disclosed in financial statements, unless the possibility of an outflow of resources embodying economic benefits is remote.
- b) Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

- c) The enterprise recognizes a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.
- d) Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made.)

### **Contingent Assets**

An enterprise should not recognize a contingent asset.

- a) Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.
- b) Contingent assets are not recognized in financial statements since they may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- c) A contingent asset is disclosed in financial statements, where an inflow of economic benefits is probable.
- d) Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognized in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an enterprise discloses the contingent asset.

### **Measurement**

The amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This means that:

- ❖ Provisions for one-off events (restructuring, environmental clean-up, settlement of a lawsuit) are measured at the most likely amount.
- ❖ Provisions for large populations of events (warranties, customer refunds) are measured at a probability-weighted expected value.
- ❖ Both measurements are at discounted present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the liability.

In reaching its best estimate, the enterprise should take into account the risks and uncertainties that surround the underlying events. Expected cash outflows should be discounted to their present values, where the effect of the time value of money is material.

If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized as a reduction of the required provision when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The amount recognized should not

exceed the amount of the provision. In balance sheet, reimbursement should be shown as an asset and provision should be shown at gross amount however, in income statement they can be netted off.

In measuring a provision consider future events as follows:

- ❖ forecast reasonable changes in applying existing technology
- ❖ ignore possible gains on sale of assets
- ❖ consider changes in legislation only if virtually certain to be enacted

#### **Re-measurement of Provisions**

- ❖ Review and adjust provisions at each balance sheet date
- ❖ If outflow no longer probable, reverse the provision to income.

#### **Application of recognition and measurement rules**

a) Future operating losses

Provisions shall not be recognized for future operating losses.

b) Onerous contracts

If an entity has a contract that is onerous, the present obligation under the contract shall be recognized and measured as a provision.

c) Restructuring

The following are examples of events that may fall under the definition of restructuring:

- Sale or termination of a line of business
- Closure of business locations
- Changes in management structure
- Fundamental re-organization of company

Restructuring provisions should be accrued as follows:

**Sale of operation:** accrue provision only after a binding sale agreement. If the binding sale agreement is after balance sheet date, disclose but do not accrue

**Closure or re-organization:** accrue only after a detailed formal plan is adopted and announced publicly. A board decision is not enough.

**Future operating losses:** Provisions should not be recognized for future operating losses, even in a restructuring

**Restructuring provision on acquisition (merger):** Accrue provision for terminating employees, closing facilities, and eliminating product lines only if announced at acquisition and, then only if a detailed formal plan is adopted 3 months after acquisition.

A management or board decision to restructure taken before the balance sheet date does not give rise to a constructive obligation at the balance sheet date unless the entity has, before the balance sheet date:

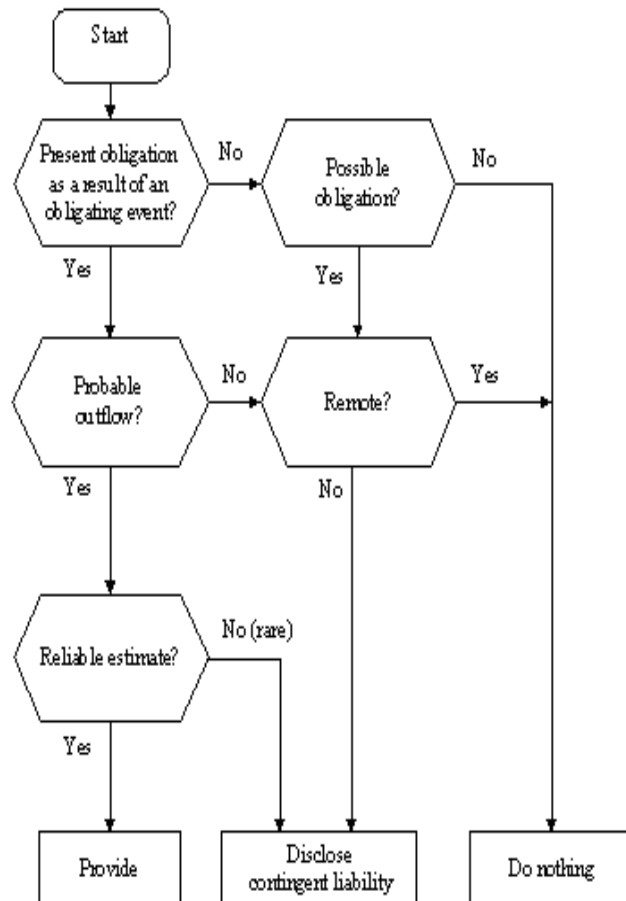
- a) stated to implement the restructuring plan; or
- b) announced the main features the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the balance sheet date, disclosure is required under

IAS 10 Events after the Balance Sheet Date, if the restructuring is material and non-disclosure could influence the economic decisions of users taken on the basis of the financial statements.

Restructuring provisions should include only direct expenditures caused by the restructuring, not costs that associated with the ongoing activities of the enterprise such as: -

- a) retraining or relocating continuing staff;
- b) marketing; or
- c) investment in new systems and distribution networks



### Examples of Provisions

Circumstance	Accrue a Provision?
Restructuring by sale of an operation	Accrue a provision only after a binding sale agreement
Restructuring by closure or re-organization	Accrue a provision only after a detailed formal plan is adopted and announced publicly. A Board decision is not enough

Warranty	Accrue a provision (past event was the sale of defective goods)
Land contamination	Accrue a provision if the company's policy is to clean up even if there is no legal requirement to do so (past event is the obligation and public expectation created by the company's policy)
Customer refunds	Accrue if the established policy is to give refunds (past event is the customer's expectation, at time of purchase, that a refund would be available)
Offshore oil rig must be removed and sea bed restored	Accrue a provision when installed, and add to the cost of the asset
Abandoned leasehold, four years to run	Accrue a provision
CA firm must staff training for recent changes in tax law	No provision (there is no obligation to provide the training)
A chain of retail stores is self-insured for fire loss	No provision until a an actual fire (no past event)
Self-insured restaurant, people were poisoned, lawsuits are expected but none have been filed yet	Accrue a provision (the past event is the injury to customers)
Major overhaul or repairs	No provision (no obligation)
Onerous (loss-making) contract	Accrue a provision