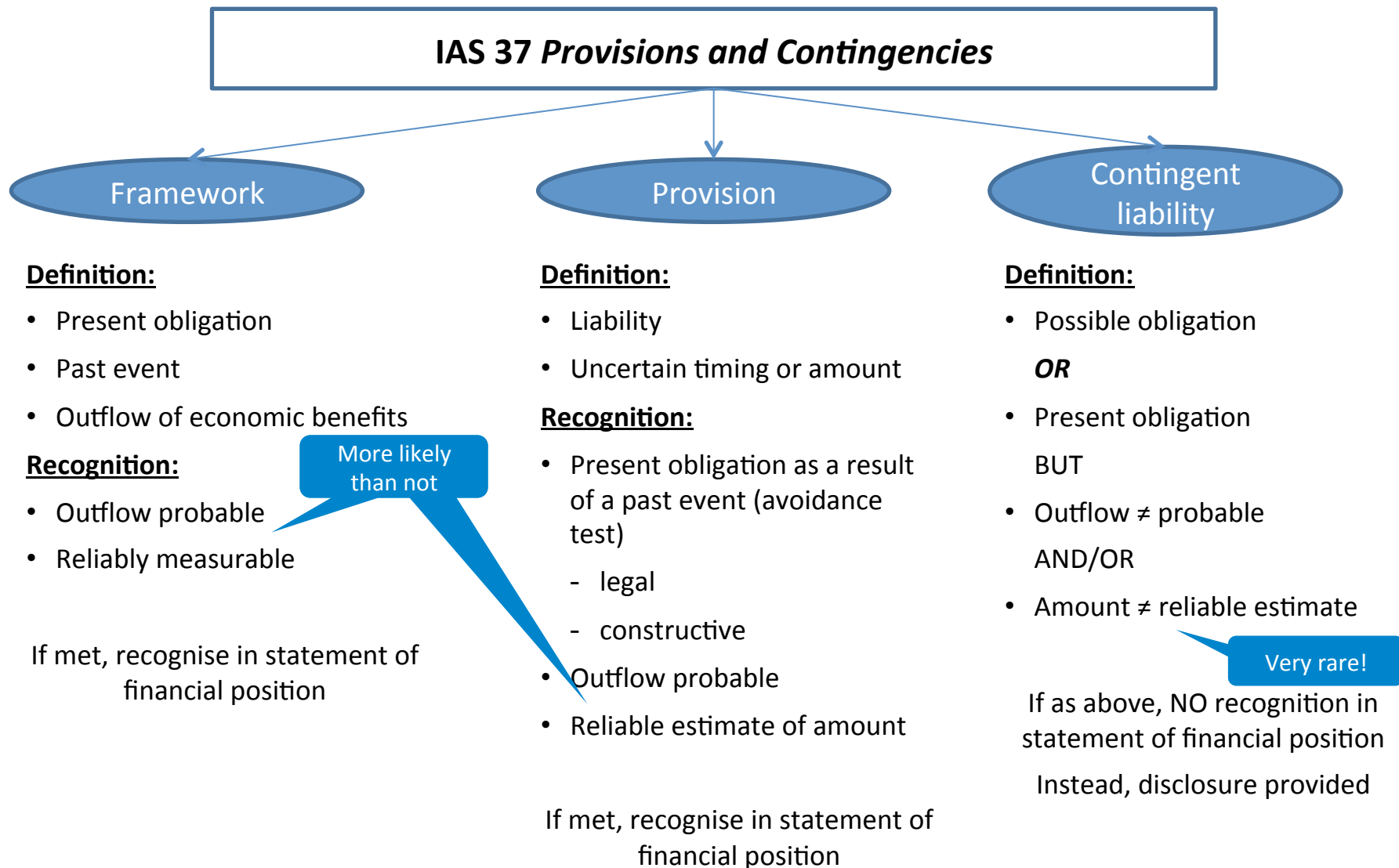


PROVISIONS, CONTINGENT LIABILITIES & CONTINGENT ASSETS IAS 37

IAS 37 Provisions, contingent liabilities & contingent assets

OVERVIEW



IAS 37 – Class Example

IDENTIFY LIABILITIES THAT ARE PROVISIONS

Identify provisions - Example

- a) Provision for bad debts
- b) Provision for leave pay (assume accumulating and vesting)
- c) Standard warranty to repair any faults that occur after customer has purchased goods
- d) Telephone bill received but not yet paid
- e) Freight costs incurred on transport of goods to your premises (invoice not yet received)
- f) Obligation to dismantle a plant and restore the site at the end of its useful life

Required: Which of the above liabilities are provisions

Which of the liabilities are provisions under IAS 37?

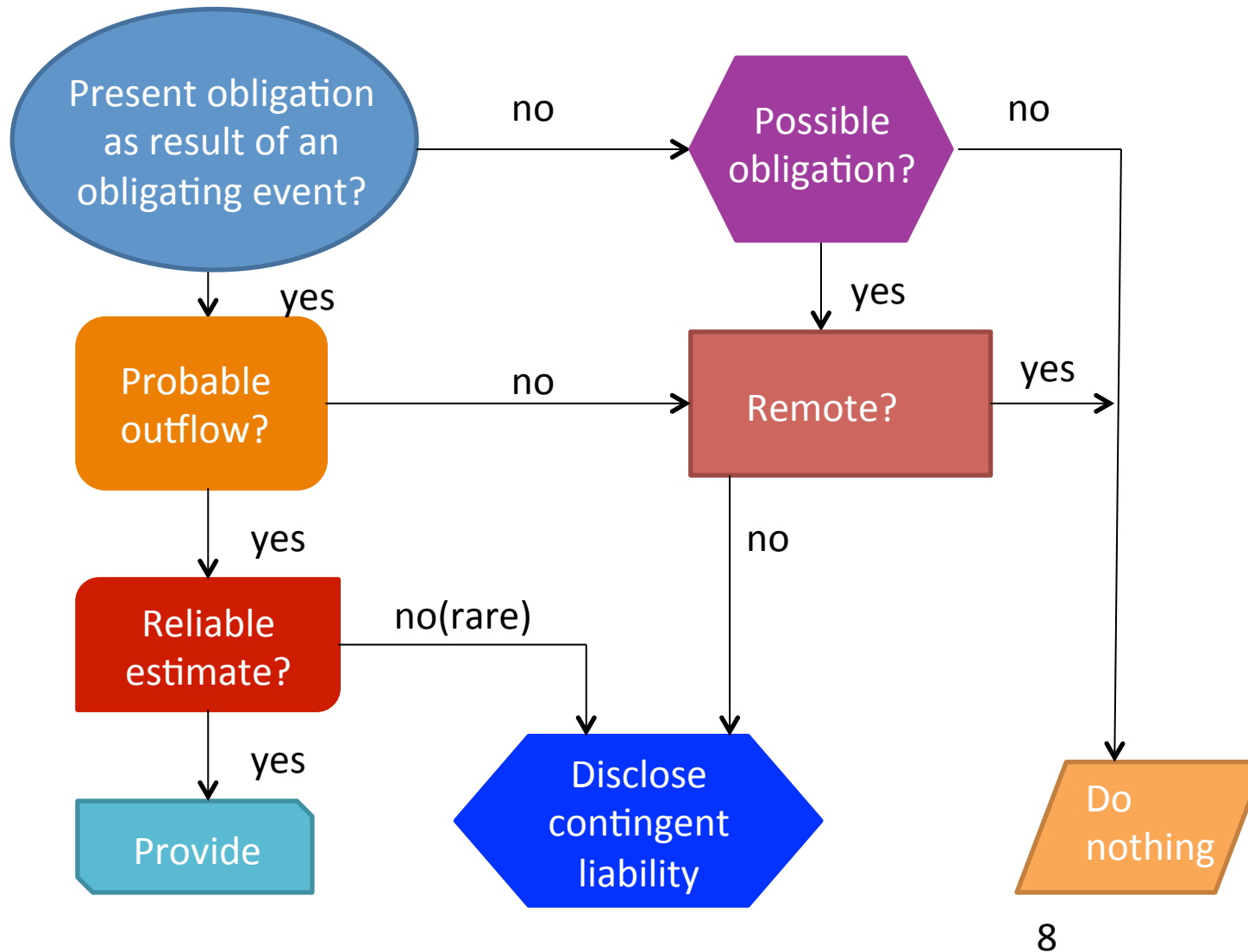
1. All of the above
2. a, b, c
3. c, f
4. a, c, f
5. b, d, e
6. None of the above

Answer:

IAS 37 Provisions, contingent liabilities & contingent assets

DECISION TREE

IAS 37 Decision tree



IAS 37 – Class Example

PROVISION OR CONTINGENT LIABILITY?

Provision or contingent liability?

- Tabaldi's building caught fire and caused damage to the neighbouring fence structure in 20X0.
- The neighbour instituted a legal claim, in terms of which judgement is yet to be passed.
- Up to the date the AFS are authorised (28/02/20X1), legal counsel is of the opinion that it is less than 50% likely (improbable) that Tabaldi will be found liable.
- On 30/08/20X1 the legal experts advise that circumstances have changed and that it is now probable that Tabaldi will have to pay a claim.
- At reporting date (year 1 = 31/12/20X0 & year 2 = 31/12/20X1), what should Tabaldi do in the AFS?

RD 1 – 31/12/20X0

What should Tabaldi do in Financial Statements?

1. Disclose a contingent liability
2. Recognise a provision for damages
3. Do nothing

Answer: _____

RD 1 – 31/12/20X1

What should Tabaldi do in Financial Statements?

1. Disclose a contingent liability
2. Recognise a provision for damages
3. Do nothing

Answer: _____

IAS 37 Provisions, contingent liabilities & contingent assets

PROVISIONS & OTHER LIABILITIES (TRADE PAYABLES AND ACCRUALS)

Provisions and other liabilities

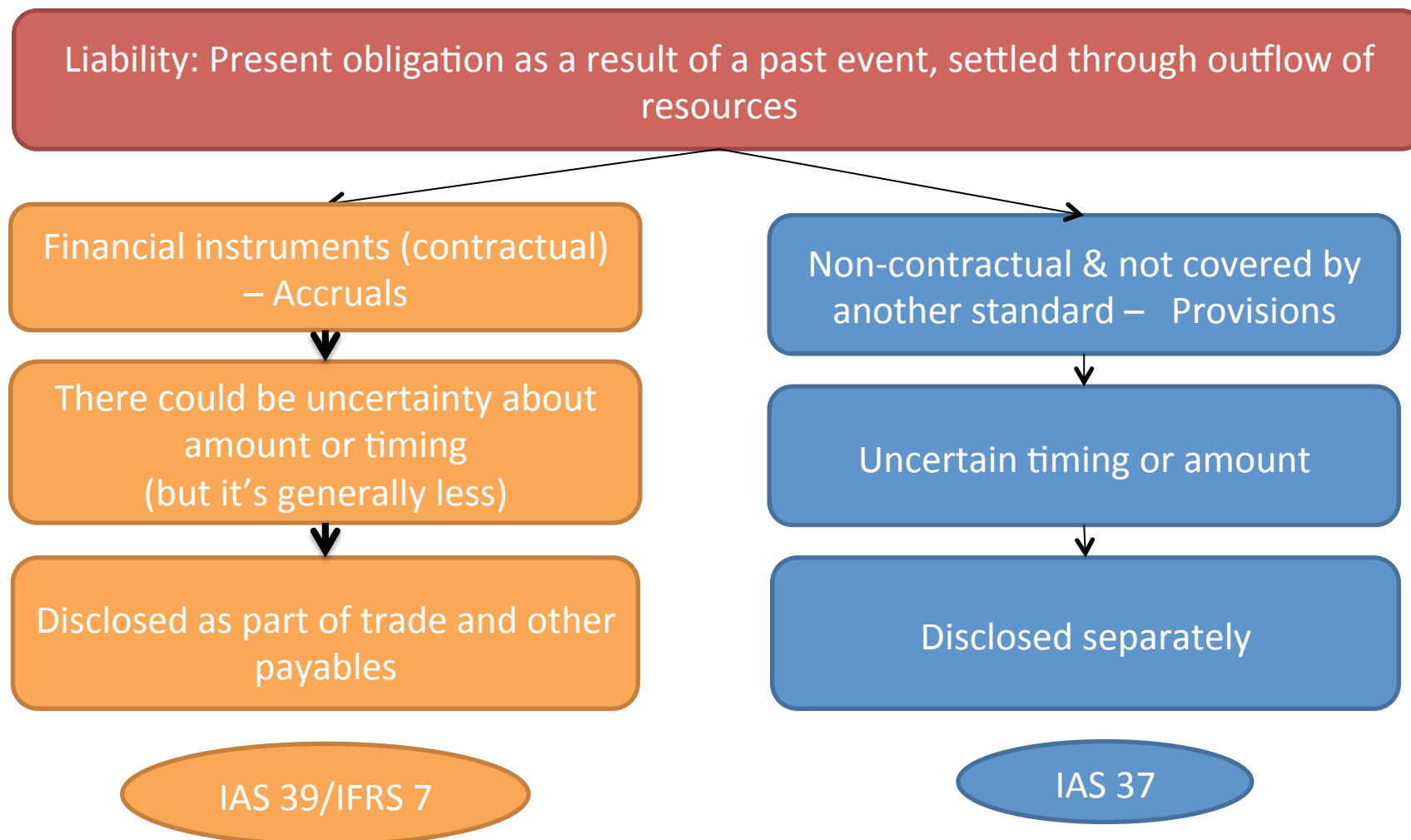
- Provisions distinguished from other liabilities such as trade payables and accruals

Trade payables = liabilities to pay for goods/services received/supplied and invoiced/formally agreed with supplier

Accruals = liabilities to pay for goods/services received/supplied but not yet paid/invoiced/formally agreed with supplier, including amounts due to employees

- Uncertain timing or amount, but uncertainty less
- Often reported part of trade payables

Accrual vs Provision



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RECOGNITION

Recognition criteria

- A provision shall be recognised when:
 - entity has present obligation (legal or constructive) as a result of a past event More likely than not
 - it is probable that an outflow of future economic benefits will be required to settle the obligation
 - a reliable estimate can be made of the amount of the obligation

Dr Expense/Asset (PL)	x	
Cr Provision (FP)		x

- If these conditions are NOT met ≠ provision to be recognised

Contingent Liability

- Shall **NOT** be recognised
 - No journal entry
- Must be disclosed
 - Unless possibility of outflow is remote
- If entity jointly and severally liable for an obligation the part which is expected to be met by other parties is treated as contingent liabilities
- Assessed continually to determine whether outflow of benefits is probable
 - If it becomes probable, a provision is recognised

IAS 37 Provisions, contingent liabilities & contingent assets

MEASUREMENT

IAS 37 Provisions and Contingencies

Provision
(cont.)

Measurement

Initial

- Weighted average of probable outcomes (future outflow before tax)
- Time value of money - discount future outflows to present value (before tax interest %)

Dr Expense/Asset (PL) x	Cr Provision (FP) x
-------------------------	---------------------

Subsequent

- Provision increases over time (unwinding of interest)
- Changes in estimates accounted for (Unused amount reduces provision, increase provision with new amount)

Dr Finance cost (PL) x	Cr Provision (FP) x
------------------------	---------------------

Dr Provision (FP) x	Cr Expense (PL) x
---------------------	-------------------

Dr Provision (FP) x	Cr Bank (FP) x
---------------------	----------------

Settlement

IAS 37 Provisions, contingent liabilities & contingent assets

INITIAL MEASUREMENT

Best estimate

- Amount to be recognised = best estimate of expenditure required to settle present obligation at end of reporting period
- Estimate of outcome and financial effect are determined by management
 - Experience of similar transactions and reports from independent experts
 - Evidence considered includes additional evidence provided by events after reporting period (IAS 10)
- Where large population of items
 - Weighing up possible outcomes by their associated probabilities (statistical method – expected value)
- Where single obligation is being measured
 - Individual most likely outcome is usually best estimate (entity still considers other outcomes)
- Pre-tax

Judgement!

Risks and uncertainties

- Risks and uncertainties surrounding amount to be recognised must be considered and dealt with according to circumstances
 - probability theory, rate of return used
- Risks describes variability of an outcome
- Risk adjustments may increase / decrease amount at which liability is measured
- Judgement
 - overstate asset / income or understate expense / liability

Probability weighted average?

Present value

- Where effect of time value of money = material
 - Amount of provision should be present value of expenditure expected to be required to settle obligation
- Provision resulting in outflows soon after reporting period
 - = more onerous than those where the same amounts arise later
- Discount rate = pre-tax rate which reflects current market assessment of time value of money and risks specific to that liability
 - Discount rates should not reflect risks for which future cash flows have been adjusted
 - i.e., caution - do not duplicate effect of time value of money

Discounting discussion

Future events

- Future events that may affect amount required to settle provision should be reflected in amount of provision
 - Where there is sufficient objective evidence that they will occur
- Examples
 - Effect of new technology where there is sufficient evidence
 - Effect of possible legislation, where such legislation is virtually certain to be enacted

Expected disposal of assets

- Gains from expected disposal of assets NOT taken into account in measuring a provision
 - Even if expected disposal is closely linked to event giving rise to provision
- Recognise gains on expected disposal of asset at time specified by relevant IFRS dealing with asset concerned

IAS 37 Provisions, contingent liabilities & contingent assets

CHANGES IN PROVISIONS

Changes in provisions

- Provision reviewed at end of each reporting period and adjusted to reflect current best estimate

Dr Expense (PL)	x
Cr Provision (FP)	x

OR

Dr Provision (FP)	x
Cr Expense (PL)	x

- If provision no longer meets criteria = reverse provision
- Where provision initially recognised at discounted amount
 - Discount unwinds, i.e., increase provision in each period
 - Recognised as finance charges



Dr Finance cost (PL)	x
Cr Provision (FP)	x

Unwinding interest

IAS 37 Provisions, contingent liabilities & contingent assets

USE OF PROVISIONS

Use of provisions

- Only for expenditures for which provision was originally recognised 
 - I.e., cannot offset unrelated expense against provision
 - Thus, show unrelated expense and provision reversed separately
- CANNOT recognise a '*general*' provision 

IAS 37 – Class Example

JOURNALISING PROVISION MEASUREMENT

Illustration

- Tabaldi Ltd has a 31 December year end and the financial statements are authorised for issue 31 January the following year.
- Tabaldi sells online accounting courses to support candidates writing professional accounting exams (board exams).
- Tabaldi has a policy to refund students who do not pass their professional board exams.
- Candidates write their exams on the 20th of December, and results are issued in June the following year.
- Based on the prior 5 years of sales and refund policies, Tabaldi management estimates that 5% of students that purchase the Tabaldi product will require refunds.

Illustration cont.

- For the year ended 31 December 20X2 the online course sales amounted to CU1,000,000.
- Based on feedback from students during a survey in March 20X3, the estimate of total refunds changed to 3% as students were more positive about results due to a new assessment product added to the Tabaldi product in 20X2.
- Results were issued in June 20X3 and 2% of students applied for refunds due to failure (lower than the updated 3% estimate).
- Time value of money is considered to be immaterial.
- At 31 December 20X3 sales amounted to CU2,500,000 and the expected refund is 2,5%.

Prepare the journals for the 20X2 and the 20X3 reporting periods to account for the refunds.

Journals – 20X2

- Raise the provision at reporting date

Journals – 20X3

- Change in estimate (March 20X3)

- Reverse unused provision (change in estimate June 20X3)

IAS 37 Provisions, contingent liabilities & contingent assets

CONTINGENT ASSETS

Definition – Contingent Asset

Contingent asset =

- possible asset that
- arises from past events whose
- existence will be confirmed by occurrence or non-occurrence of one/more uncertain future events
- not wholly within entity's control

Contingent Asset

- Shall not be recognised
 - No journal entry
- Only disclose where future economic benefits probable (>51%)
- Assessed continually for recognition as an asset
 - Virtual certainty of inflow of economic benefits = recognition of asset and related income in period in which change occurs

Liability vs Asset

PROBABILITY	LIABILITY	ASSET
Virtually certain	Recognise liability	Recognise asset
Probable	Recognise provision (liability)	Disclose contingent asset
Improbable	Disclose contingent liability	N/A

IAS 37 Provisions, contingent liabilities & contingent assets

REIMBURSEMENTS

Reimbursements

- Recovery from 3rd parties
- Insurance contracts
- Rehabilitation trust funds
- Recognise when virtually certain

Journals and offsetting?

Tricky theory

- Separate asset on statement of financial position
 - **Cannot offset the asset and provision**
- Asset canNOT exceed related provision
 - Excess = contingent asset disclosed
- Can offset in profit or loss

IAS 37 – Class Example

REIMBURSEMENTS

Reimbursements

Example

- A customer of A has established a claim against A for CU300 in respect of defective product purchased from A
- A can recover the cost of the defect and a penalty of 12% from the supplier
- Supplier has confirmed payment of CU336 (CU300 + (CU300 x 12%)) as soon as A has refunded customer

Example (a)

Should A recognise a provision?

1. Yes
2. No

Answer:

Example (b): Should A recognise a reimbursement asset?

1. Yes
2. No

Answer:

Example (c): At what amount should A recognise reimbursement asset?

1. CU300
2. CU336

Answer:

Example (d): Can A offset the reimbursement and provision in the SFP?

1. Yes
2. No
3. Yes, under certain circumstances

Answer:

Example (e): Can A offset the expense and reimbursement in PL?

1. Yes
2. No
3. Yes, under certain circumstances

Answer:

Example (f): What about the unrecognised reimbursement of 36?

1. Ignore
2. Disclose in notes
3. Recognise as a separate asset

Answer:

IAS 37 Provisions, contingent liabilities & contingent assets

FUTURE OPERATING LOSSES

Future Operating Losses

- Provision may NOT be recognised
- Not a liability
 - No past obligating event
 - *Can* be avoided by future action
- Consider whether onerous contract exists
- Expectation of future operating losses
 - Indicator of impairment
 - Test related asset (or cash generating unit) for impairment

IAS 37 – Class Example

FUTURE OPERATING LOSSES

Future operating losses

Example 1

- Tabaldi Ltd has announced a business plan to the public
- As part of the plan, Tabaldi Ltd is entering into new overseas markets
- New markets expose Tabaldi Ltd to significant increases in risk (currency, legal, political)
- The plan has been made public and is virtually certain of being implemented
- Exit strategy is extremely costly
- The board of directors feels that they will run at a loss due to this for the first 6 months of the next year and wish to raise a provision in this reporting period for those losses.

Example 1

Should Tabaldi recognise a provision?

1. Yes, general provision
2. Yes, specific provision
3. No

Answer:

IAS 37 Provisions, contingent liabilities & contingent assets

ONEROUS CONTRACTS

Onerous Contracts

Unavoidable costs of meeting the obligation **EXCEED** economic benefits expected to be received

- Not onerous if costs are merely not market-related
- First consider impairment of related assets
- Provision = least net cost of exiting
 - Lower of net unavoidable costs of fulfilling contract; and
 - Compensation or penalties from failure to fulfil

Net unavoidable costs of fulfilling contract

IAS 37 – Class Example

ONEROUS CONTRACTS – EXAMPLE 1

Onerous Contracts

Example 1

- Entity A Ltd manufactures textiles and has entered into a contract to buy a specified quantity of cotton at a cost of CU20 000
- Market prices of cotton fall dramatically and the price for the same quantity as above, is currently CU15 000
- The cotton is used to produce various products
- Expected sales of all A Ltd's products = CU35 000

Example 1

Is the contract onerous?

1. Yes, the contract costs were concluded at a higher amount than could be paid by current market price standards
2. No, expected selling price of final product (electricity) still exceeds unavoidable costs of producing the products (electricity)

Answer:

IAS 37 – Class Example

ONEROUS CONTRACTS – EXAMPLE 2

Onerous contracts

Example 2

- A Ltd has a contract to purchase one million units of gas at 23c per unit, i.e., contract price = 230 000
- Current market price for similar contract is 16c per unit, thus contract price = 160 000
- Gas will be used by A Ltd to generate electricity to be sold at a profit

Example 2

Is the contract onerous?

1. Yes
2. No

Answer:

IAS 37 – Class Example

ONEROUS CONTRACTS – EXAMPLE 3

Onerous Contracts

Example 3

- A Ltd leases office space for an annual rental of CU20 000
- Remaining lease term is 5 years
- After 2 years A has the option to cancel lease and pay CU25 000
- Cost of fulfilling contract is CU75 000 (PV of CU20 000 x 5 years)
- Cost of terminating contract is CU60 000 (PV of CU20 000 x 2 years) + CU25 000)

Example 3: What amount do we recognise for the onerous contract?

1. CU75 000
2. CU60 000
3. 0

Answer:

Journals - subsequent

IAS 37 Provisions, contingent liabilities & contingent assets

RESTRUCTURING

Restructuring Provisions

- Programme
- Planned and controlled by management
- Materially changes either
 - Scope of business undertaken; or
 - Manner in which business is conducted
- Examples
 - Sale or termination of line of business
 - Relocation of business activities
 - Reorganisation

Restructuring Provisions (cont.)

- General recognition criteria of provisions met
- **Constructive obligation** only when
 - Detailed formal **plan identifying** :
 - Business or part of business concerned
 - Principal locations affected
 - Location, function and approximate number of employees to be compensated
 - Expenditures to be incurred
 - When the plan will be implemented

AND

- **Valid expectation** created by starting to implement OR announcing plan to those affected

Restructuring Provisions (cont.)

- Restructuring costs – what to provide for?

Include if:

- Direct costs
- Unavoidable, and
- Not associated with ongoing activities



Exclude if:

- Retaining or relocating continuing staff,
- Marketing, or
- Investment in new systems and distribution network



IAS 37 – Class Example

RESTRUCTURING PROVISIONS

Restructuring Provisions

Example

- P Ltd manufactures plastic products and has various plants across the country
- P Ltd decides to shut down a plant as a result of poor performance
- P Ltd has decided to reallocate staff to the nearest plant (CU60), but some staff will be retrenched (CU40)
- Manufacturing assets will be moved to other plants (CU150)

Restructuring Provisions

Example (cont.)

- Other assets will be sold (loss on sale = CU80)
- The lease for the premises will be terminated upon payment of a penalty (CU125)
- P Ltd incurred consulting costs for the restructuring (CU25)
- P Ltd has communicated the restructuring to the employees

Example 1: What amount do we recognise as a restructuring provision?

1. 165 (40 + 125)
2. 190 (40 + 125 + 25)
3. 250 (40 + 60 + 125 + 25)
4. 375 (40 + 125 + 150)
5. 480 (40 + 60 + 125 + 25 + 60 + 150 + 80)

Answer:

Restructuring Provisions

Example (cont.)

- Costs to be included in provision:

Restructuring Provisions

Example (cont.)

- Costs considered part of ongoing operations (excluded from provision):

IAS 37 Provisions, contingent liabilities & contingent assets

OTHER EXAMPLES OF PROVISIONS – LIST FOR READING ONLY

Examples

Circumstance	Recognise a provision?
Restructuring by sale of an operation	Only when entity is committed to sale, i.e. there is binding sale agreement [IAS 37.78]
Restructuring by closure or reorganisation	Only when detailed formal plan is in place and entity has started to implement plan, or announced its main features to those affected. A Board decision is insufficient [IAS 37.72, Appendix C, Examples 5A & 5B]
Warranty	When an obligating event occurs, i.e., sale of product with a warranty and probable warranty claims will be made [Appendix C, Example 1]
Land contamination	A provision is recognised as contamination occurs for any legal obligations of clean up, or for constructive obligations if entity's published policy is to clean up even if there is no legal requirement to do so (past event is the contamination and public expectation created by entity's policy) [Appendix C, Examples 2B]
Onerous (loss-making) contract	Recognise a provision [IAS 37.66]

Examples (cont.)

Circumstance	Recognise a provision?
Customer refunds	Recognise a provision if entity's established policy is to give refunds (past event is sale of product together with customer's expectation, at time of purchase, that refund would be available) [Appendix C, Example 4]
Offshore oil rig must be removed and sea bed restored	Recognise a provision for removal costs arising from construction of oil rig as it is constructed, and add to cost of the asset. Obligations arising from production of oil are recognised as production occurs [Appendix C, Example 3]
Abandoned leasehold, four years to run, no re-letting possible	A provision is recognised for the unavoidable lease payments [Appendix C, Example 8]
CPA firm must train staff due to recent changes in tax law	No provision is recognised (there is no obligation to provide training, recognise a liability if and when the retraining occurs) [Appendix C, Example 7]
Major overhaul or repairs	No provision is recognised (no obligation) [Appendix C, Example 11]
Future operating losses	No provision is recognised (no liability) [IAS 37.63]

IAS 37 Provisions, contingent liabilities & contingent assets

DECOMMISSIONING AND REHABILITATION PROVISION

Decommissioning and Rehabilitation



IAS 16,
IFRIC 1

- Obligating event:

Decommissioning = construction or commissioning of asset
(if decommissioning required by law)

Rehabilitation = damage to environment (if rehabilitation of environment is required by law)

- Measurement

- Best estimate of expenditure to settle at reporting date
- Present value
- Pre-tax rate
- Current time value of money
- Risks specific to liability

IAS 37 – Class Example

PROVISION FOR WARRANTIES

Provision for warranties

Example

- M Ltd manufactures and sells vehicles
- All vehicles are guaranteed for 12 months
- M Ltd introduces a new model, two months before the reporting date
- At reporting date, no warranty claims have been made in respect of the new model
- However, based on experience with similar models, it is probable that there will be claims for defective vehicles

Example 1(a): Should M Ltd recognise a provision for expected claims?

1. Yes
2. No

Answer:

Example 1(b): May staff costs be included in the warranty provision?

1. Yes
2. No

Answer:

IAS 37 Provisions, contingent liabilities & contingent assets

DISCLOSURE

Disclosures Provisions

- Separate presentation of provisions in SFP
 - Provision to be used within 1 year = current liability
- Each class of provision disclosed separately
- Brief description of nature of obligation and expected timing of outflows
- Indication of uncertainties about amount or timing
- Disclose major assumptions made concerning future events

Disclosures

Provisions (cont.)

- Amount of any expected reimbursements
- Reconciliation of
 - beginning carrying amount
 - all movements
 - to end carrying amount
- Unwinding of discount
 - Presented as part of finance cost



Not for capitalisation
(IAS 23)

Disclosures

Contingent Liabilities

- Disclose contingent liabilities unless remote
- Include in note:
 - Nature of contingency
 - Estimated financial effect
 - Indication of uncertainties
 - Possibility of any reimbursement
- If impracticable, disclose this fact



Disclosures

Contingent Liabilities (cont.)

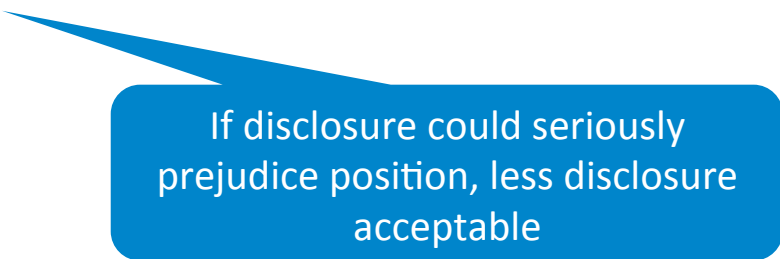
- Specific disclosure for legal claims contingent liabilities
 - Explanation of claim
 - Fact that no liability has been recognised
 - Explanation of why entity does not accept liability under claim
 - Information about estimated amount of liability or why amount cannot be estimated reliably
 - Information about any reimbursements that may be claimed if defense is not successful

If disclosure could seriously prejudice position, less disclosure acceptable

Disclosures

Contingent Assets

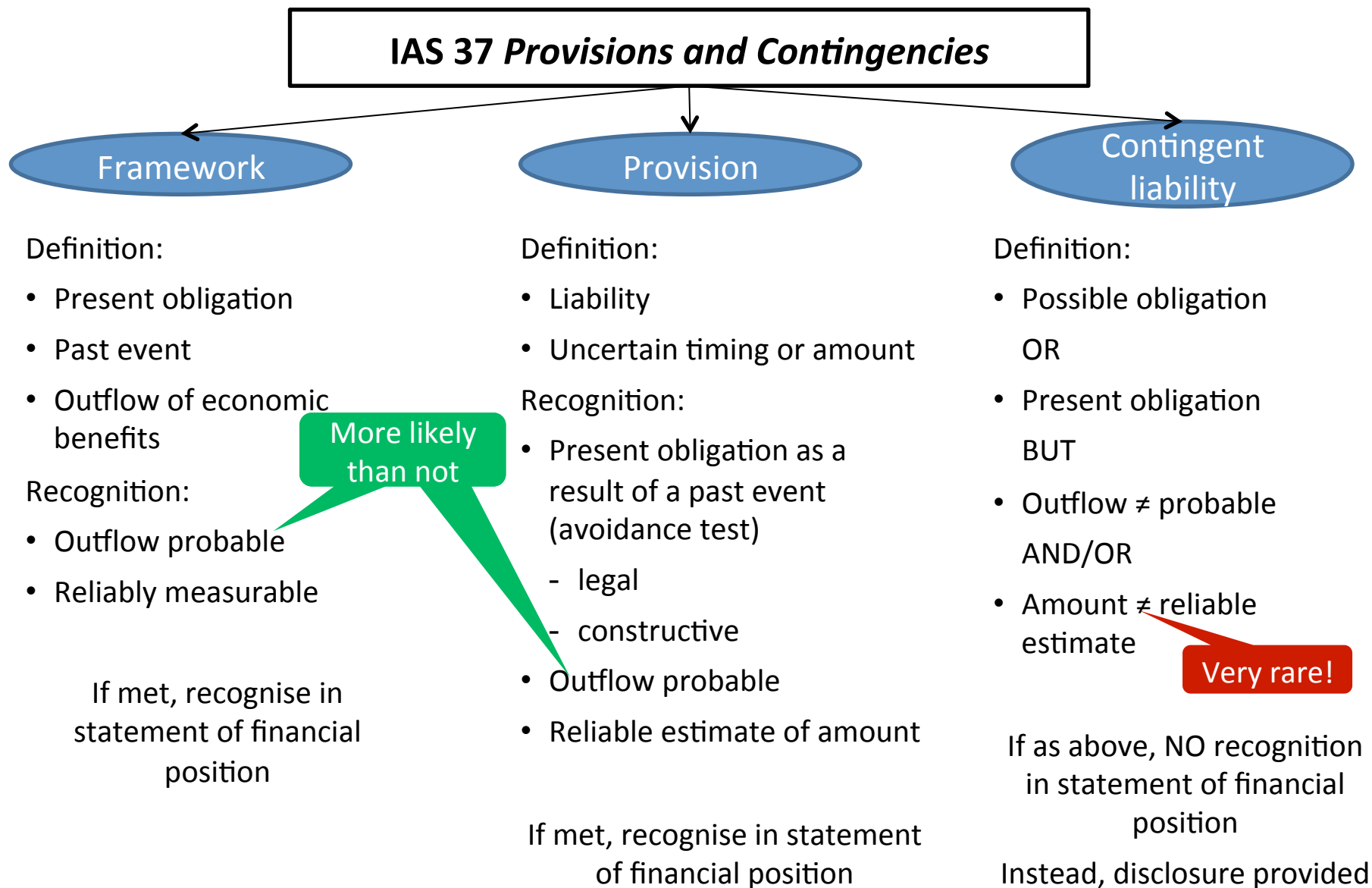
- Not recognised in SFP
 - May result in recognition of income that may never be realised
- When realisation of contingent asset is virtually certain ≠ contingent
- Disclosure required in the notes
 - Nature
 - Estimated financial effects, when practicable
 - Avoid giving misleading indications of likelihood of income arising



If disclosure could seriously prejudice position, less disclosure acceptable

IAS 37 Provisions, contingent liabilities & contingent assets

SUMMARY



IAS 37 Provisions and Contingencies

↓
Provision (cont.)
 ↓

Measurement

Initial

Subsequent

- Weighted average of probable outcomes
(future outflow before tax)
- Time value of money - discount future outflows to present value
(before tax interest %)

- Provision increases over time (unwinding of interest)
- Changes in estimates accounted for (Unused amount reduces provision, increase provision with new amount)

Dr Expense/Asset (PL) x	
Cr Provision (FP) x	x

Dr Finance cost (PL) x	
Cr Provision (FP) x	x

Dr Provision (FP) x	
Cr Expense (PL) x	x

Settlement

Dr Provision (FP) x	
Cr Bank (FP) x	x

Recap of principles

- Is it really a provision?
- Is there a present obligation?
 - IAS 37.19 (Avoidance test)
- Recognising provisions
 - Present obligation
 - Recognition criteria
- Measurement
 - Ignore expected gains from disposal of assets
 - Best estimate
 - Present value if time value of money material

Recap of principles (cont.)

- Changes in provisions
 - Reflect the current best estimate
- Use of provisions
 - Only for expenditures for which provision was originally recognised
- CANNOT recognise a ***‘general’*** provision