TOPIC 14 - IAS 37: Provisions, Contingent Liabilities and Contingent Assets

Introductory Points

- A provision is a liability of uncertain timing or amount.
- A liability is a present obligation, arising from past events, the settlement of which is expected to result in an outflow of economic benefits.
- The double entry to record a provision is:
  
  DR  Expense A/C  
  CR  Provision  

  Creating a provision therefore reduces profit, by the amount of the provision that has been created.

- Common Provisions include payment for legal damages and product guarantees given to customers.
The Need for An Accounting Standard on Provisions

Provisions were abused and used

(a) to reduce high profits in profitable years

(b) Several different items could be combined into one large all purpose provision (sometimes called “Big bath”). This was then available to be released to income to improve profits in poor performing years. i.e. the provision would be written back.

The “big bath” hypothesis suggests that if earnings are extremely low, managers are likely to take income decreasing provisions to further reduce current earnings so that (1) the probability of appearing better in the future will increase and (2) a lower benchmark for subsequent evaluation will be established

(c) Entities used provisions as a method of “moving” profits between accounting persons (“profit smoothing”).

A provision could be created or increased if an entity wanted to reduce the reported profit for one year, and then a provision could be reduced in a subsequent year, when the entity wanted to report a higher profit.
"Be 'creative'? I'm an accountant, not a novelist."
Recognising a Provision (PO – PO – RE)

1. Present Obligation Arising (PO) from a past event

2. It is probable that an outflow of economic benefits will occur to settle the obligation (PO)

3. A reliable estimate* can be made of the amount of the obligation (RE)

* Remember, a provision is a liability of uncertain timing or uncertain amount, so if the amount is uncertain, then at a minimum, we must be able to make a reliable estimate.

“Probable Outflow of Economic Benefits” = “more likely than not to occur” (> 50% chance)

Present Obligation

Constructive Obligation

Legal Obligation

Arising from a past event: The event leading to the obligation must be past and must have occurred before the end of the reporting period when the provision is first recognised.

No provision is made for costs that may be incurred in the future but where no obligation yet exists.

“Reliable Estimate”: The amount recognised as a provision should be the best estimate, as at the end of the reporting period, of the future expenditure required to settle the obligation.
Accounting For Specific Types of Provisions

1. **Onerous Contracts**

A contract where the **unavoidable** costs of completing the contract now exceed the benefits to be received.

A *provision* should be made for the additional unavoidable costs of an onerous contract.

“Additional Unavoidable Costs” are the amount by which costs that cannot be avoided exceed the benefits.

Provision

1. Obligation – Yes Legal
2. Probable Outflow of Economic Benefits? – Yes
3. Reliable Estimate – Yes

Recognise a Provision being the Present Value of the future lease payments.

2. **Restructuring**

An entity may plan to restructure a significant part of its operations. Examples of Restructuring are

(a) the *Sale or Formation* of a Line of Business

(b) the *Closure of business operations* in a country or geographical region of relocation of operations from one region or country to another

(c) Major changes in management structure e.g. the removal of an entire layer of management

(d) Fundamental reorganisations changing the nature and focus of the entity operations

A provision may be made for the future restructuring costs only if a "**present obligation exists**" (like every provision, an obligation must exist).

A *Constructive Obligation* occurs where

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(1) a detailed formal plan exists for the restructuring

(2) This plan has raised a valid expectation, in the mind of those people affected by the restructuring, that the reconstruction will occur.

So as an example, the BOD has drawn up a formal plan of restructuring and has publicly announced it (i.e. raised a valid expectation).

**Look!** – A mere management decision to restructure is not normally sufficient to create a present obligation.

Management decisions may sometimes trigger off recognition but only if earlier events such as negotiations with employee rep’s and other interested parties have been concluded subject only to management approval

Constructive: An Obligation arising from the entity actions whereby

① through past performance, published policies or a specific current statement, the entity had indicated it will accept certain responsibilities

AND

② as a result, a valid expectation has been created
1. Costs included in a Restructuring Provision
   - Direct Expenditures like redundancy costs
   - Costs not associated with the ongoing activities of the entity

2. Costs specifically excluded from a restructuring provision
   - Retraining or relocating of existing staff
   - Marketing
   - Investment in New Systems

3. Future Operating Losses

   Provisions cannot be made for future operating losses.

<table>
<thead>
<tr>
<th>Condition</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligation either legal or constructive</td>
<td>X</td>
</tr>
<tr>
<td>Probable Outflow of Economic Benefits</td>
<td>✓</td>
</tr>
<tr>
<td>Reliable Estimate</td>
<td>X</td>
</tr>
</tbody>
</table>

   So as all 3 conditions are not satisfied, no provision is made

   Prevents “Profit Smoothing”
4.

a) Environmental Contamination

“Drilling for Metals Kerry Mountains”

An entity may be required to clean up a location where it has been working when production ceases i.e. decontamination.

An entity will only recognise a provision for environmental costs only where it has a present obligation to rectify environmental damage as a result of a past event.

Legal – Required Legally to “Clean Up” Site

Constructive – Has the entity “cleaned up” similar sites before and made this public (i.e. raised a valid expectation).

The following trial balance relates to Cavern as at 30 September 2010:

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity shares of 20 cents each (note (i))</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>8% loan note (note (ii))</td>
<td>30,600</td>
<td></td>
</tr>
<tr>
<td>Retained earnings – 30 September 2009</td>
<td>12,100</td>
<td></td>
</tr>
<tr>
<td>Other equity reserve</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Revaluation reserve</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td>Share premium</td>
<td>11,000</td>
<td></td>
</tr>
<tr>
<td>Land and buildings at valuation – 30 September 2009:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land ($7 million) and building ($36 million) (note (iii))</td>
<td>43,000</td>
<td></td>
</tr>
<tr>
<td>Plant and equipment at cost (note (iii))</td>
<td>67,400</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation plant and equipment – 30 September 2009</td>
<td>13,400</td>
<td></td>
</tr>
<tr>
<td>Available-for-sale investments (note (iv))</td>
<td>15,800</td>
<td></td>
</tr>
<tr>
<td>Inventory at 30 September 2010</td>
<td>19,800</td>
<td></td>
</tr>
<tr>
<td>Trade receivables</td>
<td>29,000</td>
<td></td>
</tr>
<tr>
<td>Bank</td>
<td>4,600</td>
<td></td>
</tr>
<tr>
<td>Deferred tax (note (v))</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>21,700</td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>182,500</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>128,500</td>
<td></td>
</tr>
<tr>
<td>Administrative expenses (note (ii))</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Distribution costs</td>
<td>8,500</td>
<td></td>
</tr>
<tr>
<td>Loan note interest paid</td>
<td>2,400</td>
<td></td>
</tr>
<tr>
<td>Bank interest</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>Current tax (note (v))</td>
<td>900</td>
<td></td>
</tr>
<tr>
<td></td>
<td>340,600</td>
<td>340,600</td>
</tr>
</tbody>
</table>
(iii) Non-current assets:

Cavern revalues its land and building at the end of each accounting year. At 30 September 2010 the relevant value to be incorporated into the financial statements is $41.8 million. The building’s remaining life at the beginning of the current year (1 October 2009) was 18 years. Cavern does not make an annual transfer from the revaluation reserve to retained earnings in respect of the realisation of the revaluation surplus. Ignore deferred tax on the revaluation surplus.

Plant and equipment includes an item of plant bought for $10 million on 1 October 2009 that will have a 10-year life (using straight-line depreciation with no residual value). Production using this plant involves toxic chemicals which will cause decontamination costs to be incurred at the end of its life. The present value of these costs using a discount rate of 10% at 1 October 2009 was $4 million. Cavern has not provided any amount for this future decontamination cost. All other plant and equipment is depreciated at 12.5% per annum using the reducing balance method.

No depreciation has yet been charged on any non-current asset for the year ended 30 September 2010. All depreciation is charged to cost of sales.

(ii) Property, plant and equipment

The new plant of $10 million should be grossed up by the provision for the present value of the estimated future decontamination costs of $4 million to give a gross cost of $14 million. The ‘unwinding’ of the provision will give rise to a finance cost in the current year of $400,000 (4,000 x 10%) to give a closing provision of $4.4 million.

The gain on revaluation and carrying amount of the land and building will be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation – 30 September 2009</td>
<td>43,000</td>
</tr>
<tr>
<td>Building depreciation (w ii)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Carrying amount before revaluation</td>
<td>41,000</td>
</tr>
<tr>
<td>Revaluation – 30 September 2010</td>
<td>41,800</td>
</tr>
<tr>
<td>Gain on revaluation</td>
<td>800</td>
</tr>
</tbody>
</table>

The carrying amount of the plant and equipment will be:

- New plant (14,000 – 1,400) = 12,600
- Existing plant and equipment (67,400 – 10,000 – 13,400 – 5,500) = 38,500
- Total = 51,100

Finance costs (300 + 400 (w ii)) + 3,060 (w iv)) = (3,760)
Non-current liabilities
Provision for decontamination costs (4,000 + 400 (w (ii))) 4,400
b) Environmental Decommissioning or Abandonment Costs

“Shell to Sea Campaign” – Mayo

When an oil company initially purchases an oilfield, it may be put under legal obligation to decommission the site at the end of its life. IAS 37 states that a legal obligation exists on the initial expenditure on the field and therefore a liability exists immediately.

The present value of the future decommissioning costs are to be capitalised as they are seen as a cost of purchasing the oilfield.

5. Future Repairs to Asset

Furnace

The Furnace Lining has to be replaced every 5 years. If the lining is not replaced the furnace will break down.

IAS 37 prohibits provisions from future repairs to assets.

Why? An entity almost always has an alternative to incurring the expenditure, even if it is required by law.

E.g. the Entity could sell the furnace or stop using it.

So an entity must have an obligation to incur the expenditure for a provision to be recognised.

Normal repair costs are expensed to profit or loss.

The replacement of the furnace lining should be capitalised and depreciated as normal.
6. Warranties

Example

- Company gives warranties at the time of sale to buyers of its products
- Warranty is for 2 years from date of sale
- Past experience (trend analysis) has shown that warranty cost is about 5% of Total Sales Revenue
- Annual Sales are $1,000,000

Question

Can the company provide for warranty claims at year end??

Solution

Provision

1. Obligation?? Yes There is a legal obligation as the provision of the warranty is part of the terms and conditions of sale.
2. Probable Outflow of Economic Benefits Yes as based on past experience, a certain amount of customers will use their warranty
3. Reliable Estimate of Outflow Yes 5% of Sales Revenue

CR Provision 100,000 ($1,000,000 x 5% x 2 yrs)
DR 1/S 100,000
General Points

- The event leading to the obligation must be past
- No Provision is made for costs that may be incurred in the future but where no obligation yet exists

Probable Outflow of Economic Benefits

- >50% Chance

It is only permissible to make provisions arising from changes in the law if the legislation has been enacted or there is reasonable certainty (> 50%) as to the legal obligations that will be in force. Draft legislation cannot create a legal obligation unless it is virtually certain that the law will be drawn up as per the draft.

Contingent Liabilities and Contingent Assets

Contingent Liabilities

- A contingent liability arises when some, but not all, of the criteria for recognising a provision are met.

Which are the criteria for recognising a provision?

PO – PO – RE

- For example, a contingent liability exists if
  - a reliable estimate cannot be made or
  - there is merely a possible outflow of economic benefits (≤ 50%), or
  - There is a possible obligation (not present) 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 there is a present obligation, but only a possible outflow of economic benefits
Contingent Asset

A contingent asset is

- A possible asset
- Arising from past events
- Whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events.

An example of a contingent asset might be a possible gain arising from an outstanding legal action against a 3rd party.

The existence of the asset (the money receivable) will only be confirmed by the outcome of the legal dispute.

Recognising Contingent Liabilities or Contingent Assets

In some circumstances contingent liabilities or assets should be disclosed in the notes to the financial statements

- Contingent Liabilities should be disclosed unless the possibility of any outflow in settlement is remote
- Contingent assets should be disclosed only if an inflow in settlement is probable. Probable is defined in IAS 37 as “more likely than not”.

And if an inflow is virtually certain, the item is an actual asset that should be recognised in the SOFP.

<table>
<thead>
<tr>
<th>CONTINGENT ASSETS</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Virtually Certain”</td>
<td>Recognise</td>
</tr>
<tr>
<td>“Probable”</td>
<td>Disclose</td>
</tr>
<tr>
<td>“Possible”</td>
<td>Do Nothing</td>
</tr>
</tbody>
</table>
Examples
A company expects to receive damages from a legal action and this is virtually certain – an asset is recognised
A company expects to probably receive damages of $100,000 – A contingent asset is disclosed
A company thinks it may receive damages, but it is not probable – no disclosure.

Summary: liabilities, provisions, contingent liabilities and contingent assets

The following table provides a summary of the rules about whether items should be treated as liabilities, provisions, contingent liabilities or contingent assets.

<table>
<thead>
<tr>
<th>Liability</th>
<th>Provision</th>
<th>Contingent Liability</th>
<th>Contingent Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present obligation/asset arising from past events?</td>
<td>Yes</td>
<td>Yes</td>
<td>Only a possible obligation</td>
</tr>
<tr>
<td>Will settlement result in outflow/inflow of economic benefits?</td>
<td>Expected outflow</td>
<td>Probable outflow – and a reliable estimate can be made of the obligation</td>
<td>Not probable outflow – or a reliable estimate cannot be made of the obligation</td>
</tr>
<tr>
<td>Treatment in the financial statements</td>
<td>Set up a liability</td>
<td>Set up a provision (a type of liability)</td>
<td>Disclose as a contingent liability (unless the possibility of outflow is remote)</td>
</tr>
</tbody>
</table>
Key Question to Ask in Deciding whether to recognise a provision or not? –

Can the future cost/expense be avoided? – If on avoiding, then create a provision
Decision tree
An Appendix to IAS 37 has a decision tree, showing the rules for deciding whether an item should be recognised as a provision, reported as a contingent liability, or not reported at all in the financial statements.

More Examples
The chief accountant of a construction company is finalising the work on the financial statements for the year ended 31 December 2004. She has prepared a list of all the matters that might require some adjustment or disclosure under the requirements of IAS 37:

i. A customer has lodged a claim for repairs to an office block built by the company. A large crack has appeared in a load bearing wall and it appears that this is due to
negligence in construction. The company is negotiating with the customer and will probably have to pay for repairs that will cost €300,000 approx

ii. The wall in (i) above was installed by a subcontractor employed by the company. The company’s lawyers are confident that the company has a strong claim to recover the whole of any costs from the subcontractor. The chief accountant has obtained the subcontractor’s latest financial statements. The subcontractor appears to be almost insolvent with few assets

iii. Whenever the company finishes a project it gives customers a period of 3 months to notify any construction defects. These are repaired immediately. The statement of financial position as at 31 December 2003 carried a provision of €180,000 for future repairs. The estimated cost of repairs to completed contracts as at 31 December 2004 is €120,000

iv. During the year ended 31 December 2004 the company lodged a claim against a large firm of electrical engineers who had delayed the completion of a contract. The engineering company’s directors have agreed in principle to pay €320,000 compensation. The company’s chief accountant is confident that this amount will be received before the end of March 2005

v. An architect has lodged a claim against the company for the loss of a notebook computer during a site visit. He alleges that the company did not take sufficient care to secure the site office and that this led to the computer being stolen while he inspected the project. He is claiming for consequential losses of €100,000 for the value of the vital files that were on the computer. The company’s lawyers have indicated that the company might have to pay a trivial sum in compensation for the computer hardware. There is almost no likelihood that the courts would award damages for the lost files because the architect should have backed them up if they were important.

Explain how each of the matters (i) to (v) should be accounted for

i. This liability is virtually certain to arise, and the amount can be accurately predicted. The full cost should be accrued as an expense and as a current liability

ii. This is an asset but its recovery is remote because the subcontractor has insufficient assets to meet the claim against it. No mention should be made of this counterclaim in the financial statements

iii. This liability will probably arise. The enterprise should recognise the closing balance of €120,000 as a current liability. The movement of the provision should be taken to statement of profit or loss

iv. This asset will probably be recovered. Given that there is no written agreement, it would be safer to disclose this as a note to the financial statements
v. There is a remote possibility of a material payment. This matter should not be mentioned in the financial statements, not even in the notes. The prospects of making a payment are so unlikely that it would be misleading to say anything.

And Some More Examples

A company is engaged in a legal dispute. The outcome is not yet known. A number of possibilities arise:

- It expects to have to pay about €100,000. A provision is recognised
- Possible damages are €100,000 but it is not expected to have to pay them. A contingent liability is disclosed
- The company expects to have to pay damages but it is unable to estimate the amount. A contingent liability is disclosed.
- The company expects to receive damages of €100,000 and this is virtually certain. An asset is recognised
- The company expects to probably receive damages of €100,000. A contingent asset is disclosed

The company thinks it may receive damages, but it is not probable. No disclosure

Legal Requirement to Fit Smoke Filters

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 2000. The entity has not fitted the smoke filters

(a) At the balance sheet date of 31 December 1999

Present Obligation as a result of a Past Event – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation

Conclusion – No provision is recognised for the cost of fitting the smoke filters

(b) At the balance sheet date of 31 December 2000

Present Obligation as a result of a past Obligating Event – there is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters) However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non compliant operation of the factory)
Probable Outflow of Economic Benefits – Assessment of probability of incurring fines and penalties by non compliant operation depends on the details of the legislation and the stringency of the enforcement regime

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely then not to be imposed

Past Exam Questions:
- Q3 (5) April 2015
- Q5 April 14
- Q2 Aug 2013
- Q3 (5) April 13
- Q3 April 2011,