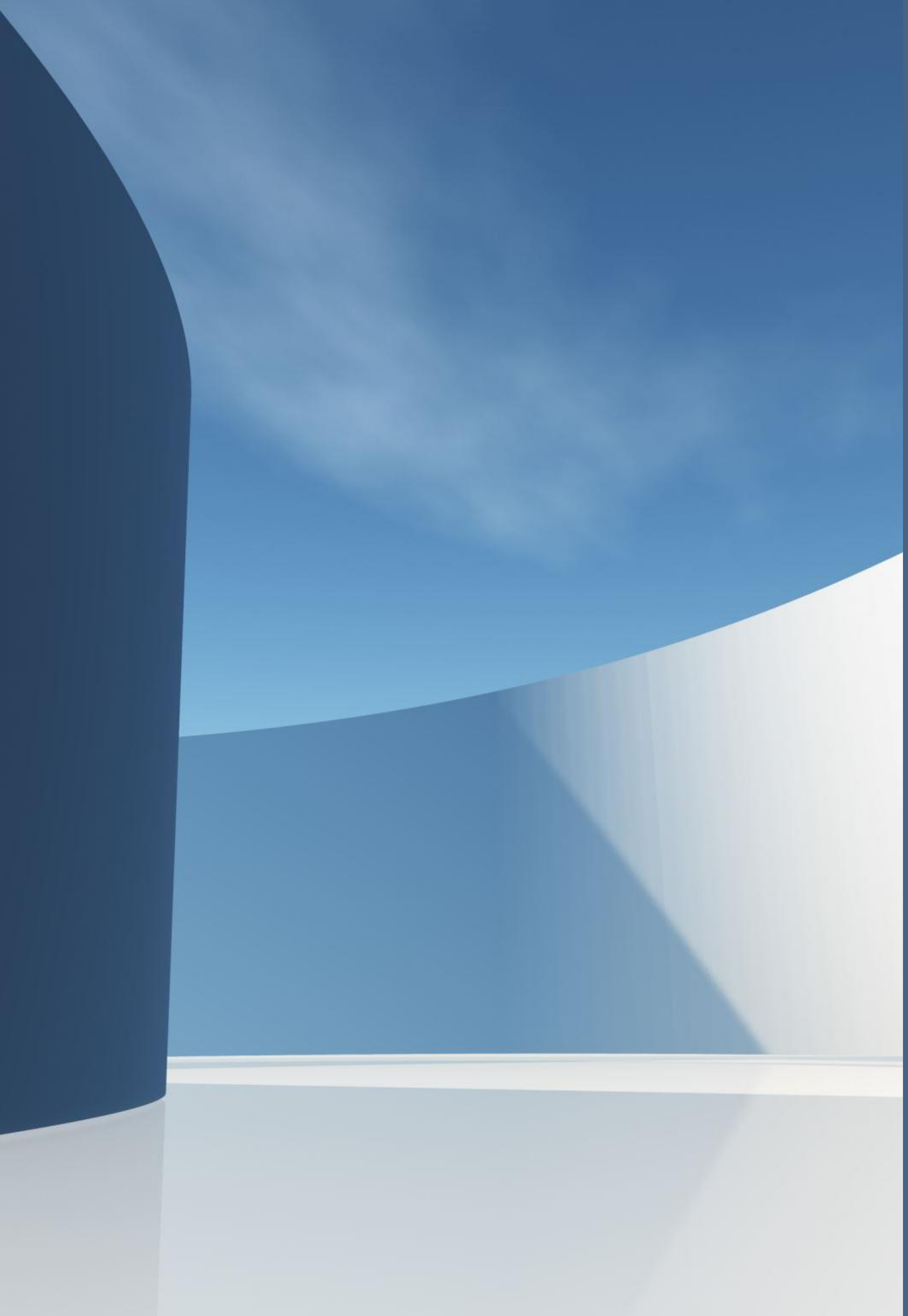

FINANCIAL REPORTING

IAS 37: Provisions, Contingent Liabilities and Contingent Assets

OBJECTIVE OF THE STANDARD

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.

SCOPE OF THE STANDARD

The standard applies to accounting for provisions, contingent liabilities and contingent assets except those arising from;

- Financial instruments (including guarantees) under IFRS 9
- Insurance contracts under IFRS 4 (but applies to other provisions, contingent assets and liabilities of the insurer.
- Non-onerous executory contracts
- Items specifically covered by another standard such as IAS 12 applies to obligations for current or deferred income taxes, IFRS 16 on lease obligations, IAS 19 on employee benefits, IFRS 3 on contingent consideration of an acquirer in a business combination.

PROVISIONS

Definition:

A provision refers to a **liability** of **uncertain** timing or amount. Uncertainty is a key component in this definition otherwise, if the outcome is certain then we would be dealing with a payable or an accrual.

Remember the conceptual framework explains a **liability** as a present obligation of the entity to transfer an economic resource as a result of past events.

Recognition of a provision

A provision shall be recognized when:

- an entity has a **present obligation** (legal or constructive) as a result of a **past event**
- a **reliable estimate** can be made of the amount of the obligation
- it is **probable** that an outflow of resources embodying economic benefits will be required to settle the obligation

All the three conditions must be met for a provision to be recognized.

- **Present obligation**

According to IAS 37, the present obligation can either be;

- **Legal/contractual:** An obligation that derives from a contract (thru its explicit or implicit terms), legislation or other operation of law.
- **Constructive:** This arises where the company establishes a valid expectation (in other parties that the entity will discharge responsibilities created) through a course of past practice, published policies or a sufficiently specific current statement, regardless of whether there is a legal requirement to perform the task or not.

PROVISIONS CONT'D

Key to note: there must be an obligation to pay in the future, but not an intention to pay. An intention to pay is not sufficient to recognize a provision.

- **Past event**

A past event that leads to a present obligation is called an **obligating event.**

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

- **Reliable estimate/measurement (criteria)**

Provisions should be recognized at the **best estimate**. Therefore;

- If a provision relates to one event, e.g., a potential liability from a court case, environmental clean up etc., it is measured using the **most likely outcome**.
- But if it's made up of numerous events, e.g., a provision to make repairs on goods sold within a year, customer refunds etc., then it is measured using **expected values**.

PROVISIONS CONTINUED

Note I: Risks and uncertainties (such as inflation) that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision. A risk adjustment may increase the amount at which a liability is measured. The adjustment should however not lead to an overstatement of incomes and asset as well as an understatement of expenses and liabilities.

Note II: An amount of a provision may need to be discounted where the effect of time value of money is material. In this case, the provision shall be the present value of the expenditures expected to be required to settle the obligation. The provision may need to be unwound until the actual expenditure is finally made with the increment being an expense (finance costs) as well as increasing in the provision amount.

Note III: Entities normally try to involve other parties to pay part, or all of the expenditure required to settle the provision such as insurance companies. Such reimbursements are only recognized when it is virtually certain that it will be received if the entity settles that obligation. They are recognized as a separate asset (not as a reduction in the provision) and it must not exceed the amount of the provision.

Note IV: Provisions must be reviewed at the end of each period and adjusted to reflect the current best estimate. A provision will be reversed if it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Note V: When the expenditure is finally incurred and settlement of the obligation made, the provision must be utilized (written off)

- **Probable outflow of economic resources**

The likelihood of the event has to be probable. If its not, but there is a possible liability, then an entity shall record a contingent liability instead.

PROVISIONS CONTINUED

Presentation of provisions

- Presented as liabilities in the SFP categorizing them as either current or non-current depending on when they are expected to be utilized.
- Respective entry recognized as an expense in the SOPL However, sometimes a provision can be recognized as part of the cost of an asset instead of recognizing an expense such as provisions for restoration/dismantling costs.

In case the provision relates to a long-term period and time value for money was incorporated at initial measurement (as explained above), then at the end of each reporting period the discounted figure of the provision needs to be unwound by computing finance costs as a product of the opening provision and the discount rate. The finance costs will be presented as expenses in the SOPL as well as increasing the opening balance of the provision.

CONTINGENT LIABILITIES AND ASSETS

Contingent liability: IAS 37 defines a contingent liability as;

- 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
- a **present** obligation that arises from past events but is not recognized because:
  - it is not **probable** that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - the amount of the obligation cannot be measured with sufficient reliability.

A contingent liability is **not recognized**, but rather **disclosed** as a note to the financial statements. This means, no entries are made into the entity's financial statements.

Contingent assets: IAS 37 defines a contingent asset as 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.

Similar to a contingent liability, a contingent asset is also **not recognized** in the financial statements, it is rather disclosed in the notes to those financial statements where an inflow of economic benefits is **probable**. This is because they may result into recognition of incomes that may never be realized, but if the realization of that income finally becomes certain, then that ceases to be a contingent asset hence worthy of full recognition as an asset in the financial statements.

In summery;

Degree of probability	Outflow	Inflow
Certain	Recognize a liability	Recognize an asset
Probable	Recognize provision	Disclose a contingent asset
Possible	Disclose a contingent liability	Ignore
Remote	Ignore	Ignore

SPECIAL AREAS OF APPLICATION

Future operating losses

No provision shall be recognized for future operating losses. This is because they do not meet the definition of a liability and the criteria for recognition of a provision, and they are avoidable.

Future repair costs can also not be recognized as provisions because they relate/arise to/in the future and hence avoidable. An asset requiring repair can be sold just like a unit making losses.

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.

The unavoidable costs under a contract represent the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

The cost of fulfilling the contract comprises the costs that relate to the contract directly which can either be;

- incremental costs of fulfilling that contract such as direct labour, material costs, or
- an allocation of other costs that relate directly to fulfilling contracts such as an allocation of the depreciation charge for an item of PPE used in fulfilling the contract.

If an entity has a contract that is onerous, the present obligation under the contract is recognized and measured as a provision being the lower of:

- the cost of fulfilling the contract; and
- penalties arising from failure to fulfil it.

SPECIAL AREAS OF APPLICATION

Restructuring

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

- the scope of a business undertaken by an entity, or
- the manner in which that business is conducted.

Examples of a restructuring includes a sale or termination of a line of business, closure of business locations in a country or region or relocation, changes in management structure, fundamental reorganizations that have a material effect on the nature of the entity's operations.

A provision for a restructuring is recognized if the recognition criteria is met. A constructive obligation occurs when;

- ❖ An entity has a detailed, formal and approved plan identifying;
    - The business or part of the business concerned
    - The principal locations affected
    - The expenditure that will be undertaken
    - When the plan will be implemented
    - The expected number of employees who will be compensated for terminating their services
- ❖ The plan has been announced to those affected raising a valid expectation in them.

Note that the provision must include direct expenditure arising from the restructuring, and exclude costs associated with ongoing activities.

APPLICATIONS CONTINUED

Warranties

There is either a legal or constructive obligation to make good or replace/repair faulty products.

A provision is required at the time of the sale rather than the time of the repair/replacement since the making of the sale is the past event which gives rise to an obligation. However, this requires an entity to make estimates based on past experience on how many claims will be made and how much each repair will cost.

The provision made at the time of the sale shall be based on the expected number of repairs in the future and the expected cost per repair. However, this provision is reviewed at the end of each accounting period for appropriateness and possible reversal.

Guarantees

A provision should be made for this guarantee if it is probable that the payment will have to be made. An example is one entity making a guarantee on behalf of another to pay off a loan, if the other entity is unable to do so.

DISCLOSURES

An entity shall disclose the following for each class of provision;

- the carrying amount at the beginning and end of the period
- additional provisions made in the period, including increases to existing provisions
- amounts used (i.e. incurred and charged against the provision) during the period
- unused amounts reversed during the period
- the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

For each class of contingent liability;

- a brief description of the nature of the contingent liability
- an indication of the uncertainties relating to the amount or timing of any outflow
- the possibility of any reimbursement.

Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period.

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November 2019 Qn 1 (5) and Qn 5 (b)

May 2023 Qn 3 (3)