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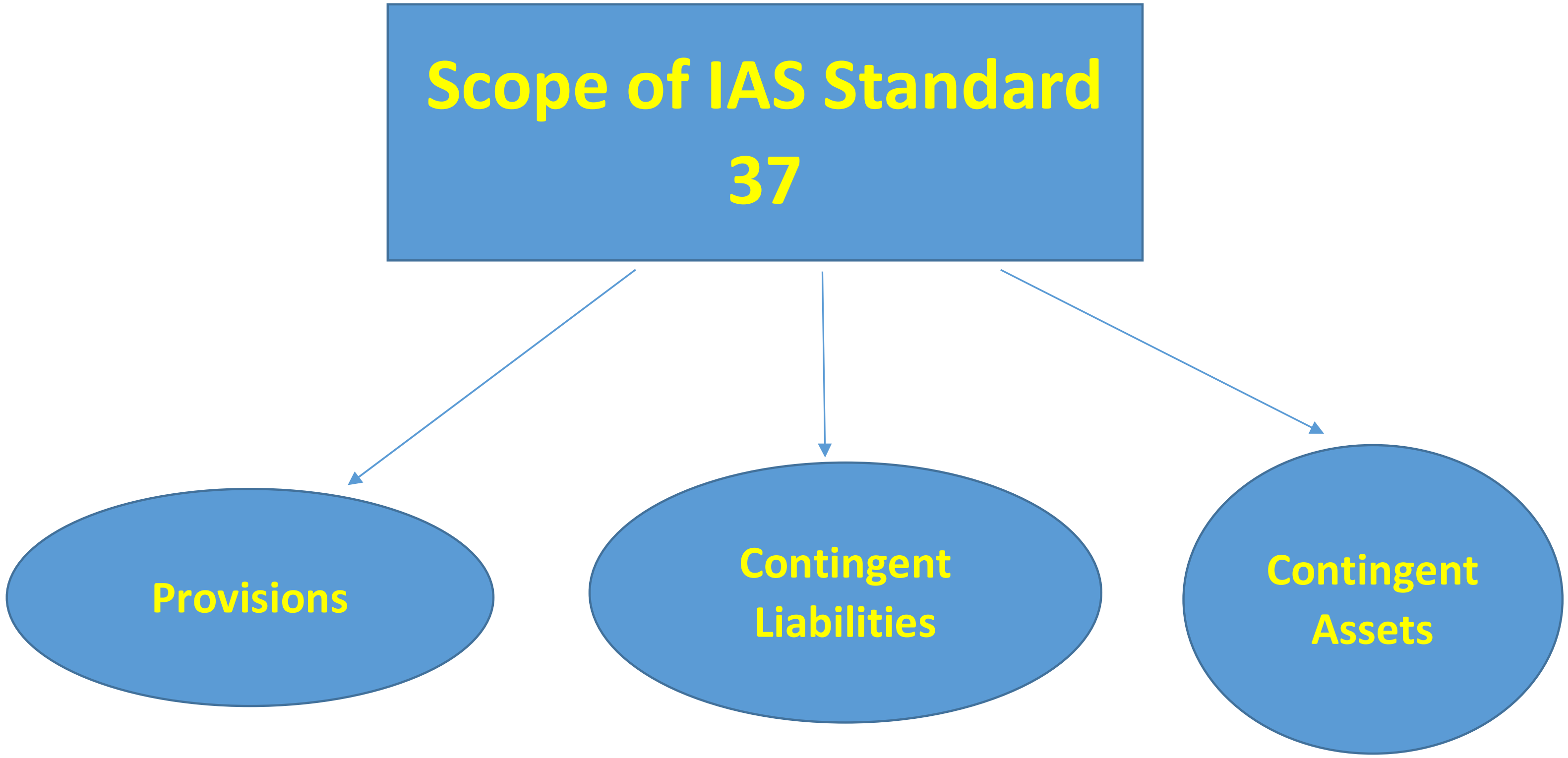
A Digital Learning Platform for Generation Z: Passport to IFRS®

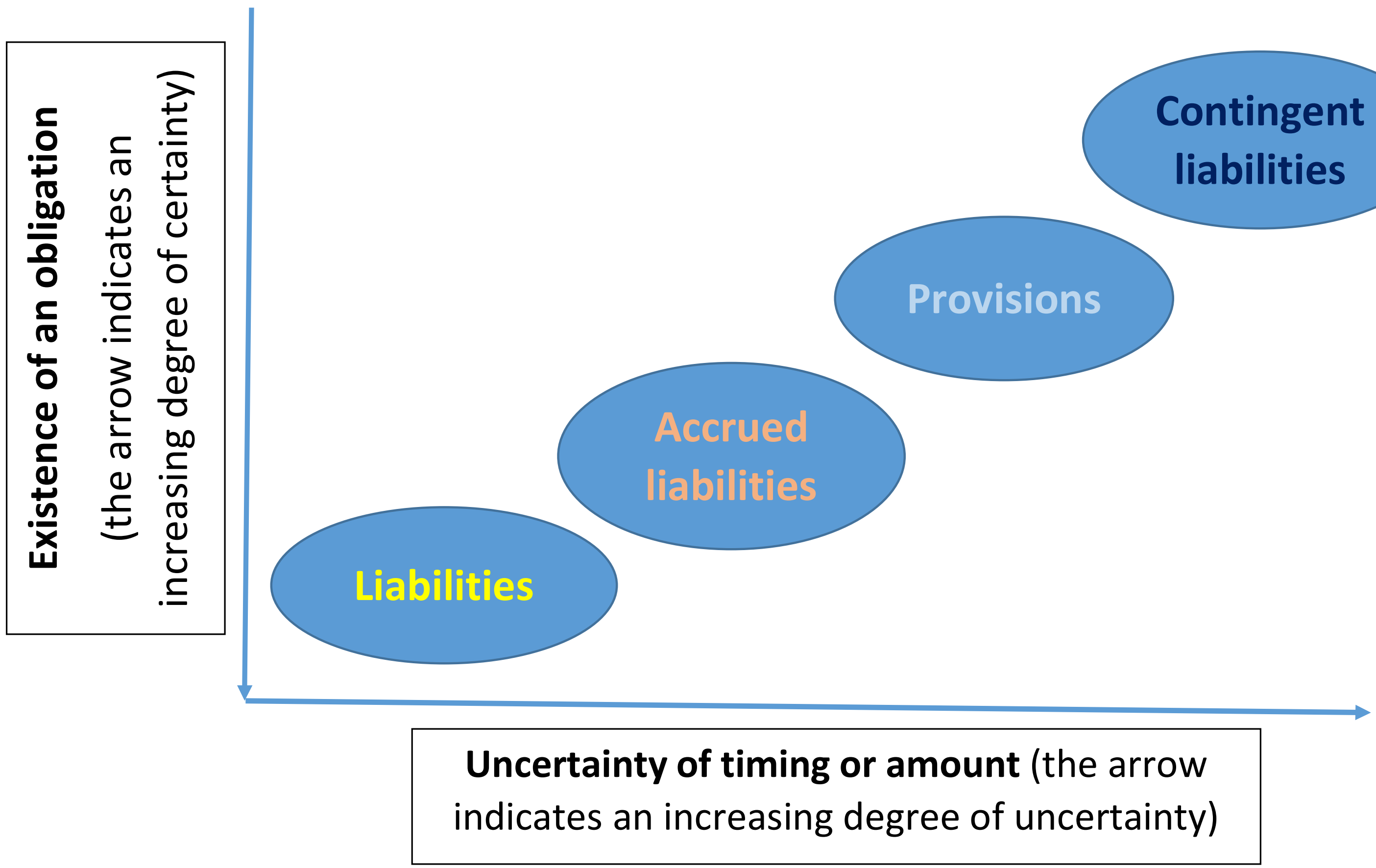
IAS® Standard 37 Provisions, Contingent Liabilities and Contingent Assets

Co-funded by the Erasmus+ Programme of the European Union

OBJECTIVE AND SCOPE



LIABILITIES – RELATED CONCEPTS



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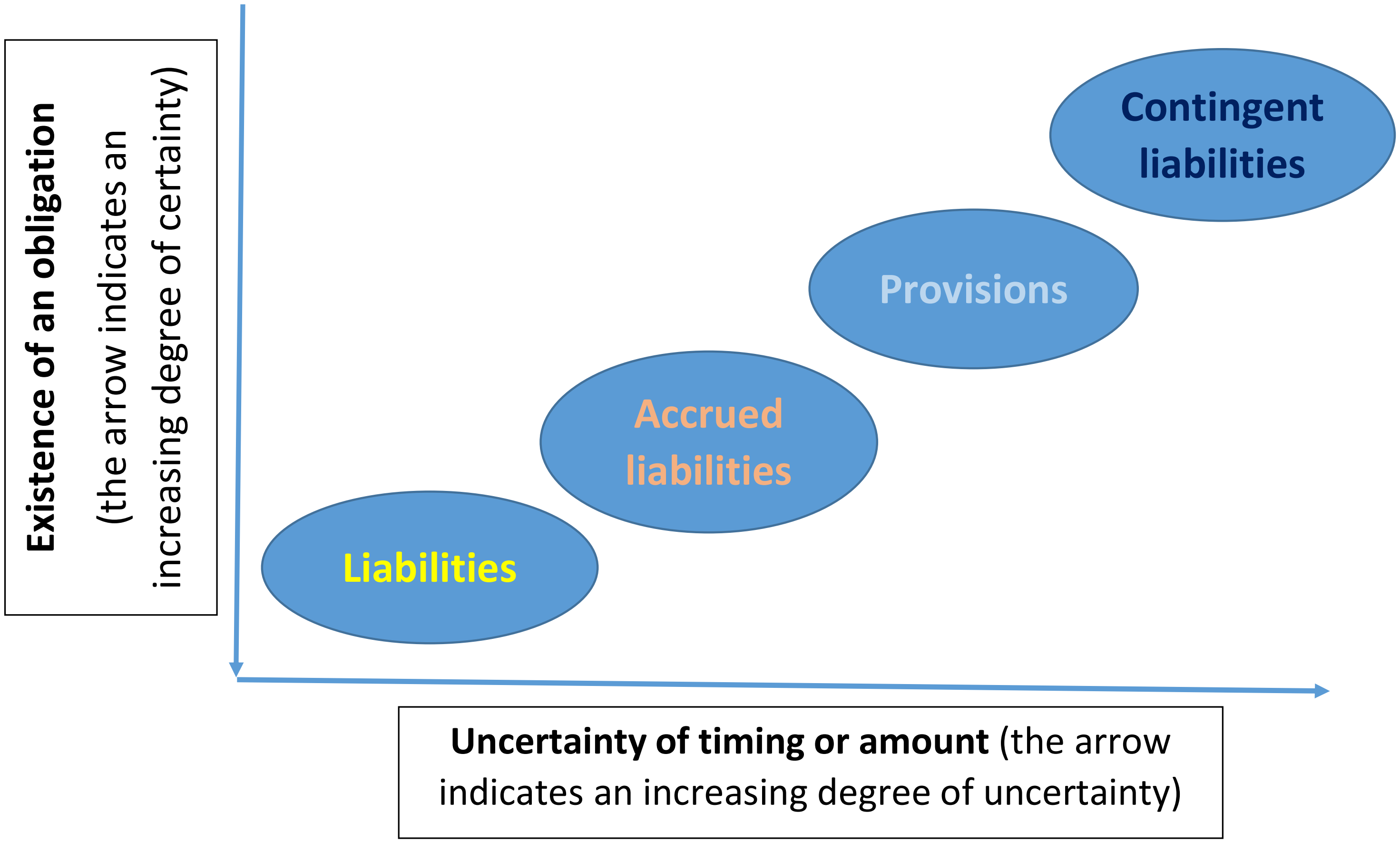

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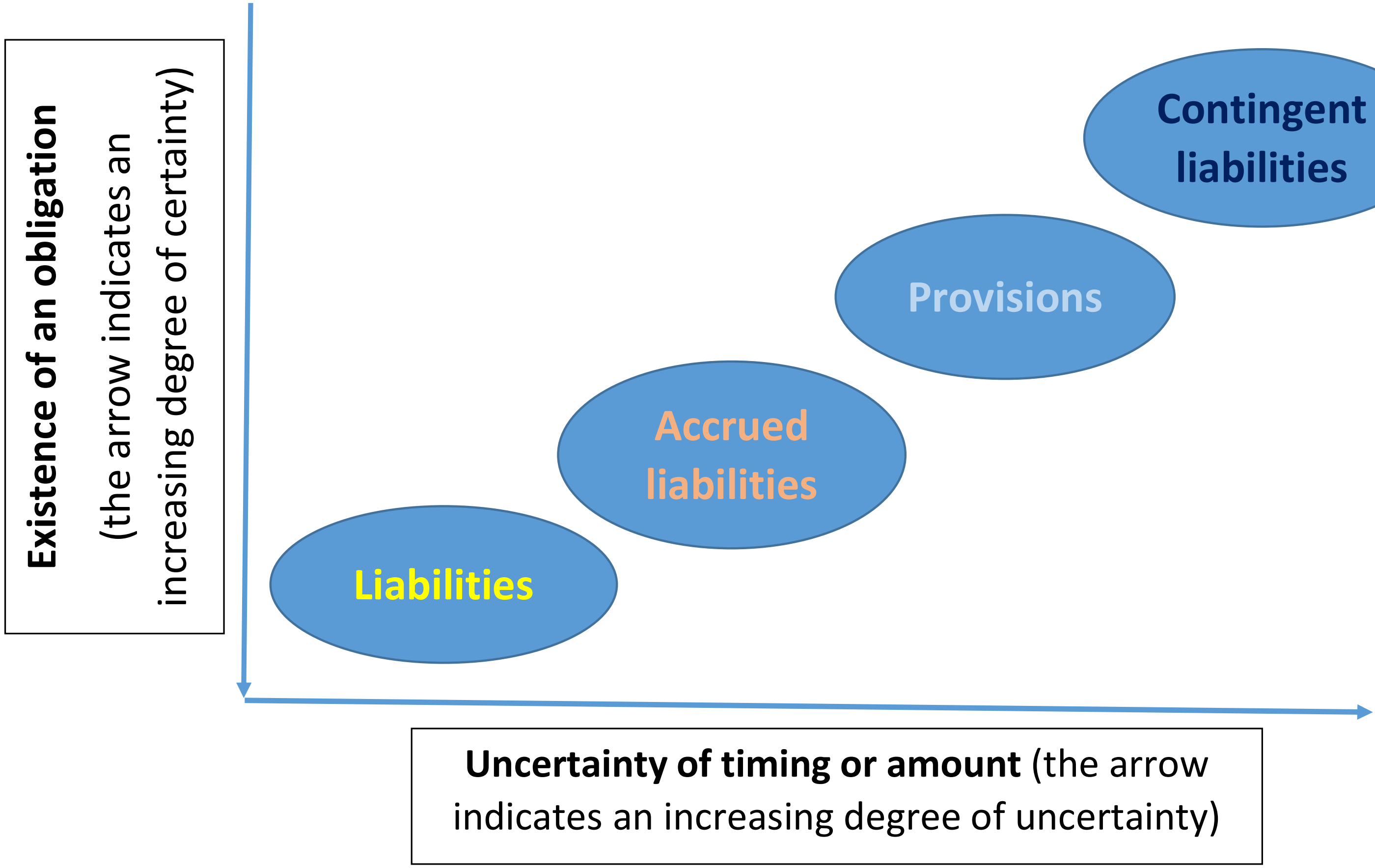

RECOGNITION OF PROVISIONS

Provisions are recognised when:

1. an entity has a present obligation (legal or constructive) as a result of a past event

2. it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation

3. a reliable estimate can be made of the amount of the obligation

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3. a reliable estimate can be made of the amount of the obligation

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

CONTINGENT LIABILITIES

A contingent liability is:

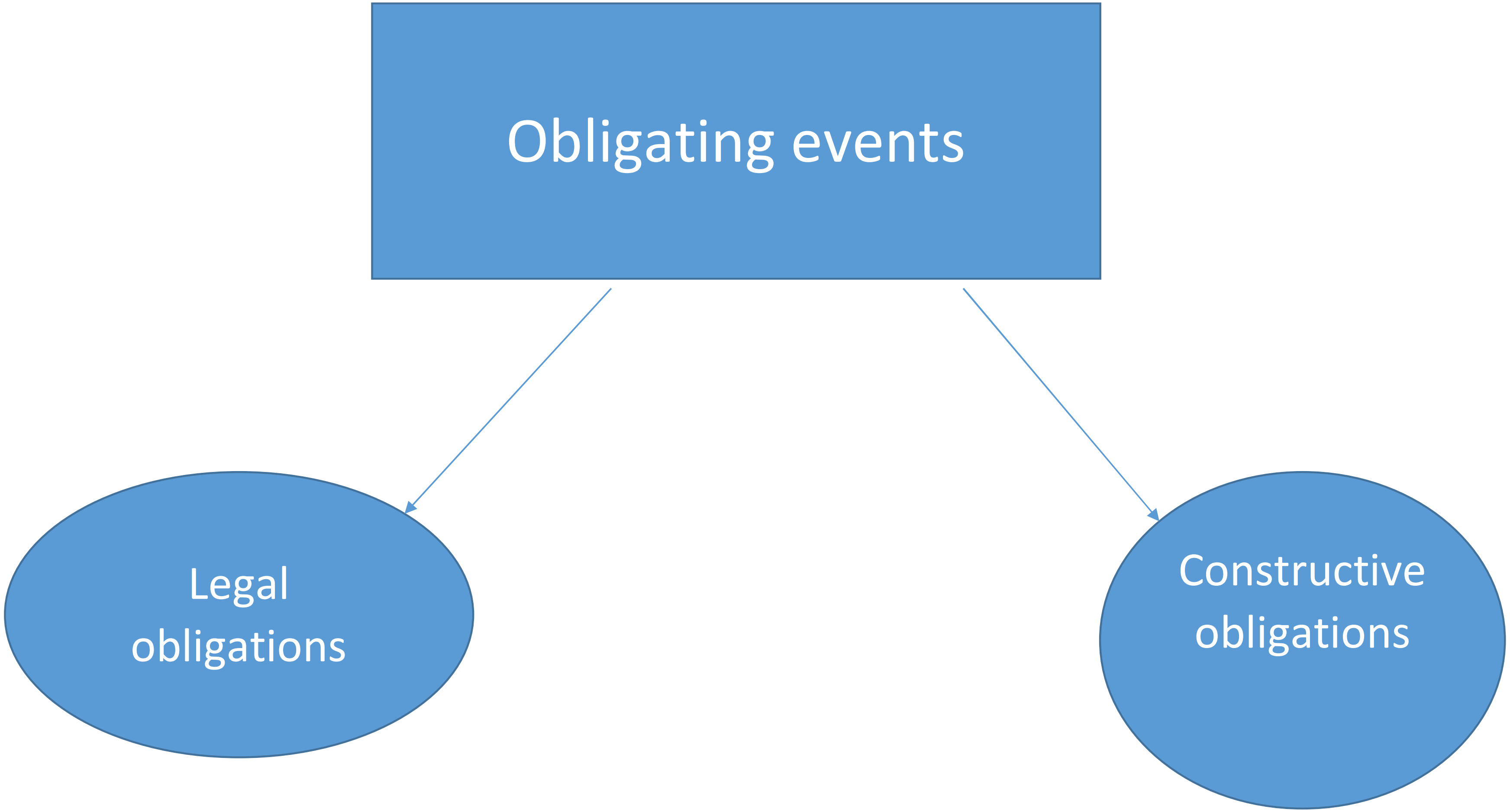
- a **possible obligation** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; OR

CONTINGENT LIABILITIES

A contingent liability may also be:

- 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.*

OBLIGATING EVENTS



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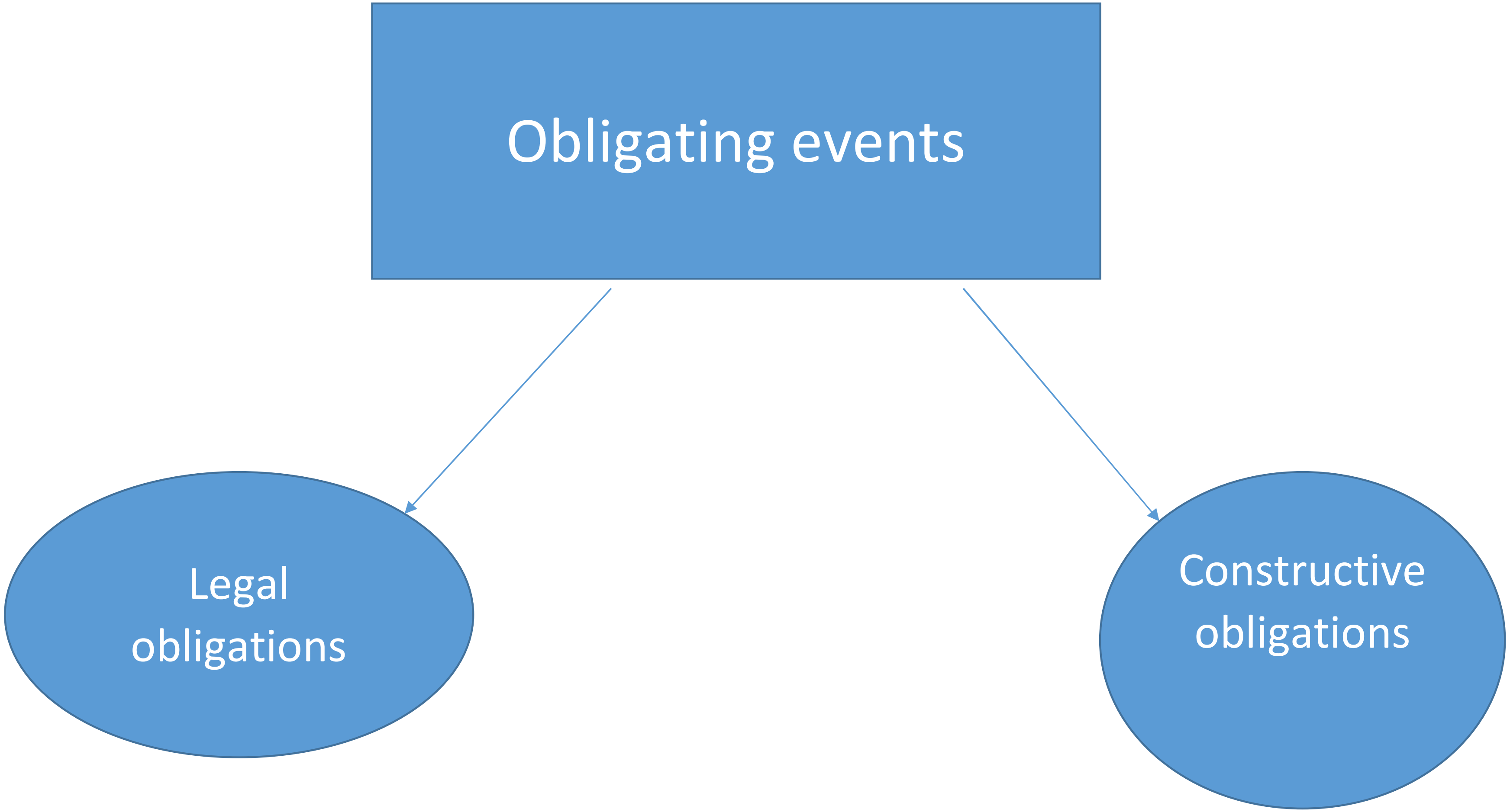
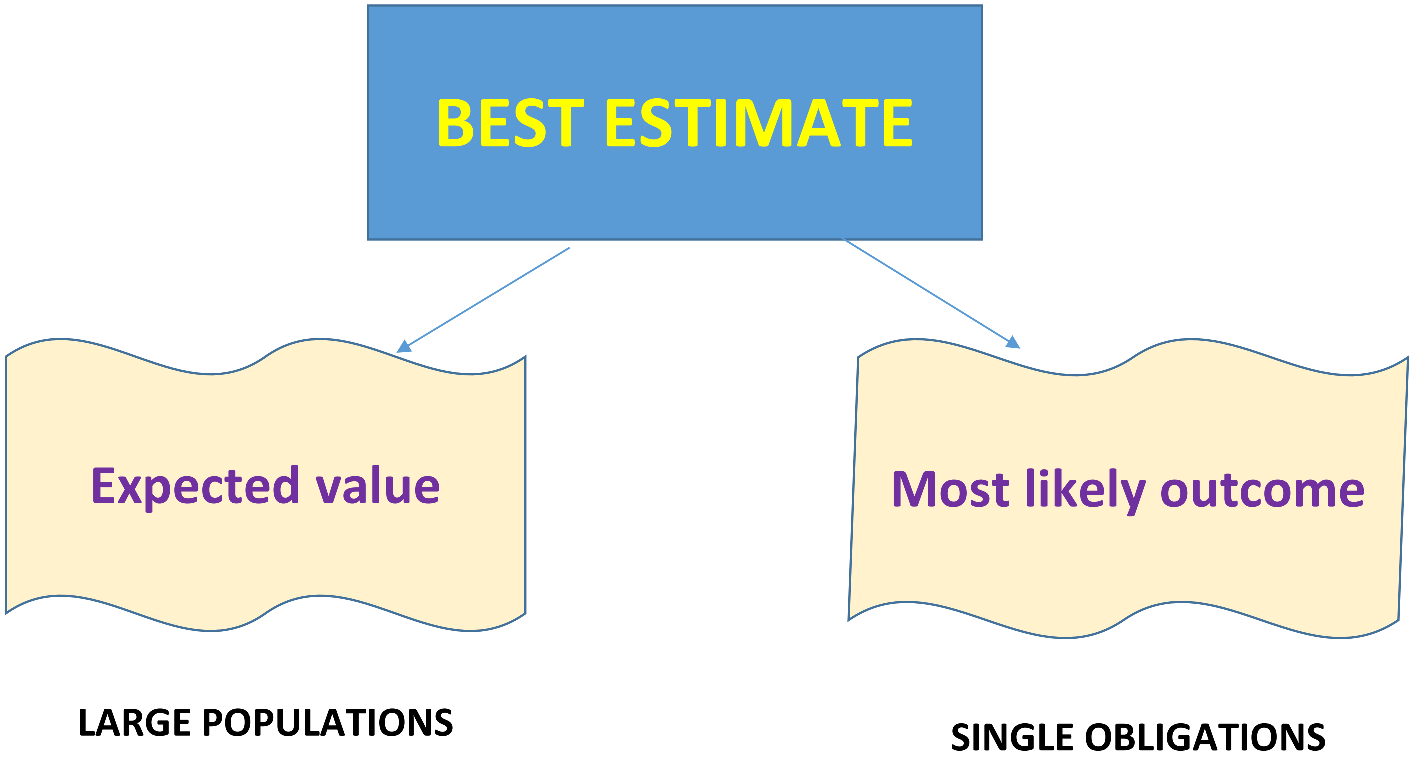


MEASUREMENT OF PROVISIONS



MEASUREMENT OF PROVISIONS: expected value

Lavander is a manufacturer of toys and sold 10,000 puppets during 2020. Experience shows that 5% of the toys sold need small repairs, with an average cost of CU10, and 1% need replacement (at CU50 each).

How should the entity measure its provisions?

MEASUREMENT OF PROVISIONS: expected value

Lavander entity sold 10,000 puppets during 2020. Experience shows that 5% of the toys sold need small repairs, with an average cost of CU10, and 1% need replacement (at CU50 each).

Provisions= 5%*10,000 units*CU10 + 1%*10,000*CU50

SMALL REPAIRS **REPLACEMENT**

Warranty provisions = CU10,000

MEASUREMENT OF PROVISIONS: most likely outcome

An entity's management estimates a 30% chance that it will have to pay CU2,000,000, and a 70% chance to have to pay CU300,000 as a result of a lawsuit.

How should the entity measure its provisions?

MEASUREMENT OF PROVISIONS: most likely outcome

An entity's management estimates a 30% chance that it will have to pay CU2,000,000, and a 70% chance to have to pay CU300,000 as a result of a lawsuit.

How should the entity measure its provisions?

Option 1: Provisions = CU300,000

MEASUREMENT OF PROVISIONS: expected value

An entity's management estimates a 30% chance that it will have to pay CU2,000,000, and a 70% chance to have to pay CU300,000 as a result of a lawsuit.

How should the entity measure its provisions?

Option 2: Provisions = 30%*CU2,000,000+70%*CU300,000

= **CU810,000**

MEASUREMENT OF PROVISIONS: discounted value

Regardless of their estimate, provisions are measured at the discounted value of the future expenditures, where the time value of money differs significantly over time. The increase in the amount of the provision is a finance cost that goes through profit or loss. The discount rate is a pre-tax rate that reflects both the current market assessments of the time value of money and the specific risks of the liability.

MEASUREMENT OF PROVISIONS: present value

An entity operates a manufacturing plant for which the licensing agreement requires it to decommission the plant at the end of its useful life. The entity estimates a cost of CU10,000 to be settled in 3 years. The discount rate is 5%.

How should the decommissioning cost be measured?
How will the entity record these adjustments?

MEASUREMENT OF PROVISIONS: present value

$$\text{Present value of the expenditure} = \frac{10{,}000}{(1+0.05)^3} = \text{CU}8{,}638$$

Date	Provision at the beginning of the period (CU)	Finance cost (CU)	Provision at the end of the period (CU)
T0			8,638
T1	8,638	8,638*0.05=432	9,070
T2	9,070	9,070*0.05=454	9,524
T3	9,524	9,524*0.05=476	10,000

The provision increases from CU8,638 to CU10,000.

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Dr. Finance cost 432

Cr. Decommissioning provisions 432

DISCLOSURE

(1) a reconciliation between the beginning and the ending amounts of the provision, by indicating any increases and decreases due to use or release during the period.

(2) the nature and circumstances of each provision, as well as the timing and assumptions around the related outflows. *Comparative information is not required.*

(3) information about each of its contingent liabilities and how likely the possibility of any expenditure arising from them is.

(4) when an inflow of economic benefits is probable (not *only possible*), entities should also disclose information about their contingent assets.

EXAMPLE

Several people were hurt following an event in October 2020, and they accused the event organizer of mismanagement. The organizer does not agree with these allegations. A lawsuit began by the end of the year 2020, but the organiser's lawyers advised it before the financial statements were approved for the year to 31 December 2020, that it is probable that the organiser will not be found liable.

However, before the organiser prepares its financial statements for the year to 31 December 2021, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable for damages of approximately CU100,000.

What are the consequences of this series of events on the entity's financial statements?

EXAMPLE

In 2020 the entity does not need to recognise a provision for this event, as its lawyers advise against it being ordered to pay any compensation as a result of the lawsuit. The entity might disclose the appropriate information in the form of a contingent liability though in the notes to its financial statements, clarifying the circumstances related to these events and its assessment of a remote possibility of being found liable.

In 2021 though, the entity should change this policy by recognising a provision for litigation, of approximately CU100,000, owing to new developments around the case.

Dr. Provision expense	100,000	
Cr. Provision for litigation		100,000

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