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IAS® Standard 37 Provisions Contingent Liabilities and Contingent Assets

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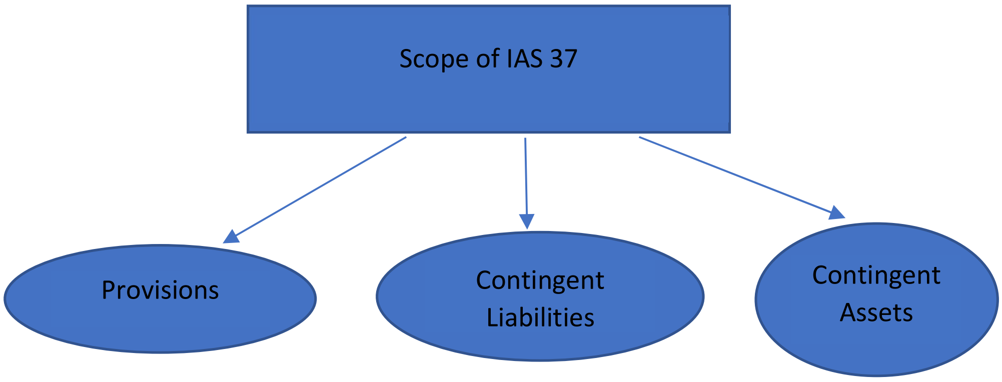
IAS® Standard 37 Provisions, Contingent Liabilities and Contingent Assets

SCOPE AND KEY DEFINITIONS

Figure 1 presents the scope of IAS Standard 37 Provisions, Contingent Liabilities and Contingent Assets.

Figure 1. The scope of IAS 37



Other standards also refer to some other specific liabilities, contingent liabilities and contingent assets, and they should be used instead of IAS 37 in those cases. Such standards include, for example, IAS Standard 12 Income taxes, IAS Standard 19 Employee benefits, IFRS Standard 3 Business Combinations, or IFRS Standard 16 Leases.

Liabilities are a big part of the entities' financial statements, alongside other items that are related to them, such as contingent liabilities or accrued liabilities. To recognize a liability in the statement of financial position, the item must comply with the appropriate definition and recognition criteria. If the item does not comply with any of these, it is not recognized in the financial statements as such but may be disclosed as a contingent liability.

As a reminder, according to the Conceptual Framework for Financial Reporting (CFFR), a liability is a present obligation of the entity to transfer an economic resource as a result of past events (CFFR4.26). For a liability to exist, three criteria must all be satisfied (CFFR4.27):

(a) the entity has an obligation;

(b) the obligation is to transfer an economic resource; and

(c) the obligation is a present obligation that exists as a result of past events.

Significant judgement is required for some items that satisfy the definition of a liability to evaluate whether they are recognized as liabilities. If a liability is not recognized, then a contingent one may exist. Individual IFRS Standards provide principles and application guidance (in particular IAS 37).

Let's say, for example, that an entity purchases raw materials, and the supplier accepts a later payment. This purchase will result in the recognition of a liability, usually in the form of accounts payable, because the purchasing entity now has an obligation to transfer some economic resource as a result of engaging in this purchase and receiving the assets.

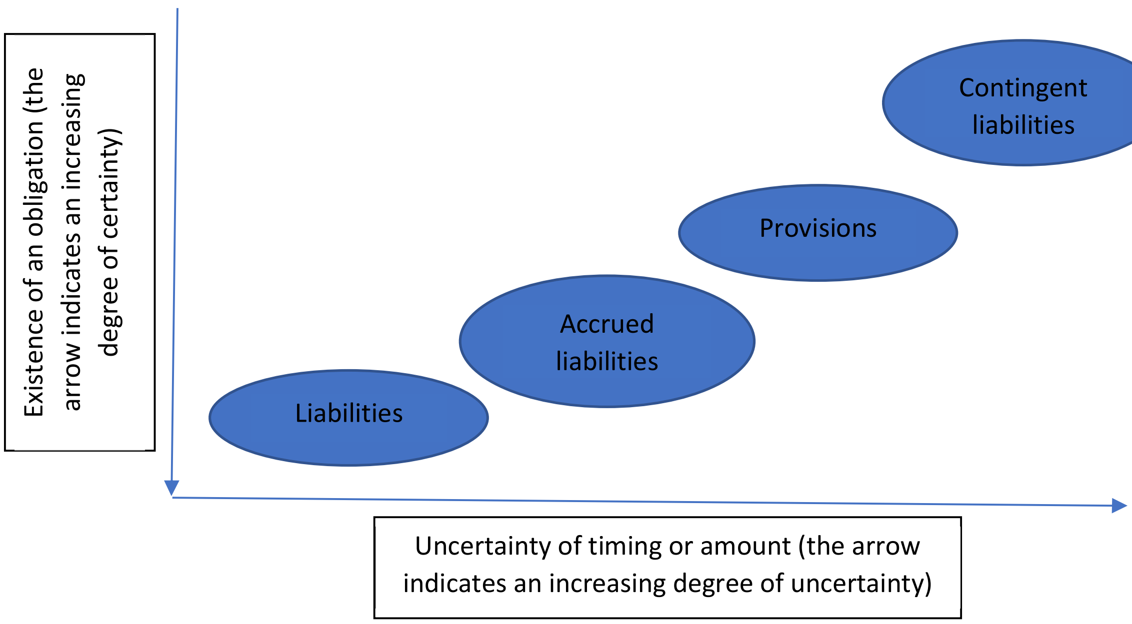
But what if the entity consumes some electricity in a certain year, although it is not exactly sure how much this electricity costs because it did not receive the invoice yet? The entity should still recognize a liability because it is able to estimate reliably its cost as a result of the consumption of electricity. In this case, the entity incurs an accrued liability whose amount must also be estimated, but with a smaller degree of uncertainty than for provisions.

Finally, what about entities that sell their products under a warranty policy? As a result of the sale, these entities must upkeep their warranty policy in the case of faulty products by either reimbursing the cost of the product or repairing it. Either way, these entities are subject to some subsequent costs as a result of this past event, thus committing to an obligation when they make the sale. This circumstance also gives rise to a liability, but in the form of a provision (for warranties).

Provisions are liabilities of uncertain timing or amount (IAS37.10). In the case of the product sale under warranty, it is uncertain whether the entity will incur any repairing or reimbursement cost, although it is obligated to do so under the law if such a case occurs, and is unsure about the exact amount of this cost. Nevertheless, warranty provisions should be recognized. Other such examples giving rise to provisions are restructuring operations or the cleaning up resulting from the entity's operations.

Significant judgement is required in many cases to determine the impact of certain transactions on the financial statements, and the difference between provisions and other types of liabilities is not always obvious. Figure 2 presents a comparison between such related concepts. In this figure, liabilities are depicted to have the smallest degree of uncertainty regarding their timing or amount, and the highest degree of certainty about the existence of an obligation. At the other extreme, contingent liabilities have the highest degree of uncertainty regarding their timing or amount, and the smallest degree of certainty about the existence of an obligation.

Figure 2. Liabilities and related concepts



RECOGNITION OF PROVISIONS

Provisions are recognised when (IAS37.14):

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

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

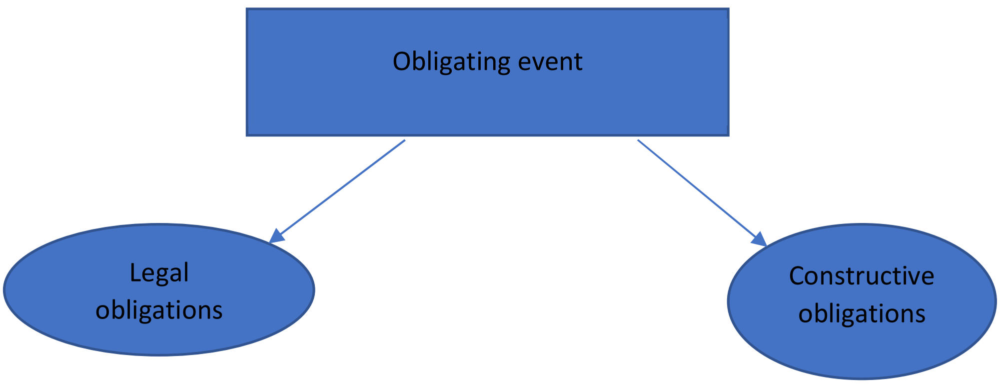
For example, let's say that a customer sued the entity over an accident allegedly caused by the products sold by the entity. The lawyers hired by the entity believe that chances to be found guilty are small. In this case, it is improbable that an outflow of resources embodying economic benefits is required to settle this case, so the entity does not recognise any provision. The entity will disclose a contingent liability in the notes to the financial statements though.

A contingent liability is (IAS37.10):

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

The recognition of provisions should result from an obligating event. Such an event is one that creates a legal or a constructive obligation for the entity (see Figure 3). Legal obligations arise from contracts or legislation, while constructive obligations arise from the entity's actions by established patterns of entity practices that create an expectation by other parties in terms of what the entity's responsibilities are. Therefore, the recognition of provisions implies that the entity has not realistic alternative to settling that obligation. Accordingly, entities will not recognize provisions for future expenses for example, under the assumption that they may be able to avoid them.

Figure 3. Type of obligations

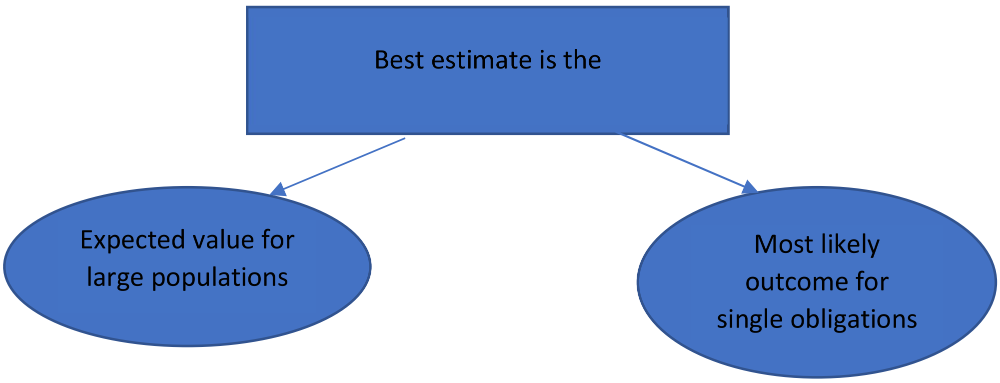


Let’s consider the case of an entity who operates in the chemical industry and its activity is polluting the environment. Will the entity recognize a provision if it operates in a country that does not impose any legislation in terms of fighting the effects of pollution, and if the entity does not have any established policy in this regard? The answer is no, as the entity does not have any legal or constructive obligation in this regard. But what if the entity makes a public statement about fighting the effects of pollution even if it is not legally required to do so in the country where it operates? Then the entity recognises a provision, because it has created an expectation as a result of its policies, and thus has a constructive obligation.

MEASUREMENT OF PROVISIONS

Provisions should be measured at the best estimate of the expenditure that the entity will incur to settle the present obligation at the end of the reporting period (IAS37.36). Management should exercise significant judgement in determining the best estimate of such expenditures, making the measurement of provisions a very challenging task. Various sources of information should be used in making these decisions, including prior experience and the opinion of independent experts. For example, the entity should consult with lawyers when discussing the implications of a lawsuit. Figure 4 provides indication of how the best estimate may be assessed by management.

Figure 4. Best estimate measures for provisions



In the case of large populations, the best estimate of provisions is determined by weighting all the possible outcomes by their associated probabilities. For example, a manufacturing entity will use this method to measure its warranty provisions by considering prior experience about faulty products returned by customers. Let’s say that the 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). How should the entity measure its provisions? The expected value for this provision amounts to CU10,000 (5%*10,000 units*CU10+1%*10,000*CU50). This estimate assumes that 94% of the units sold are not returned to the entity, thus the entity does not incur any cost related to them. This estimate is also only one source of information for management, who might consider any changes since past periods (e.g., replacement of machines or any training of workers that might lead to quality improvements, or increased warranty requirements of passed legislation or by entity policies).

Entities who deal with single obligations will consider an alternative measure which is the most likely outcome, supplemented by other sources of information. Value adjustments may be necessary depending on the specific circumstances, to account for example for other possible outcomes that may significantly differ from the most likely outcome. For example, an entity who is sued by a customer estimates to 70% the chance to win the lawsuit. In this case, the entity does not recognize any provision, as the most likely outcome is to win this lawsuit. The entity might disclose a contingent liability, though, explaining the circumstances of the lawsuit and the management's assessment of the outcome.

But what if 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? Since the most likely outcome is being ordered to pay CU300,000, this amount is one strong indicator for the lawsuit provision. Yet, the entity could up this provision to account for a larger amount that it may have to pay (i.e., 30% chance of having to pay CU2,000,000). It could also use a similar approach to large populations, i.e., to use an expected value of CU810,000 (30%*CU2,000,000+70%*CU300,000), or an amount in between these values. Regardless of its determination, management must disclose their thinking process in the notes to the financial statements.

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.

Let's consider the case of an entity operating 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, and how will the entity record these adjustments?

As the time value of money will significantly change over these three years, the decommissioning expenditure should be discounted (see Table 1 for the unwinding of the discount due to the changing time value of money, all amounts rounded up). The present value of the provision is calculated as follows:

Present value of the expenditure = $\frac{10,000}{(1+0.05)^3}$=CU8,638

The entity will journalise

Dr. Plant 8,638

Cr. Decommissioning provisions 8,638

Table 1. The unwinding of the discount

Date	Provision at the beginning of the period	Finance cost	Provision at the end of the period
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 yearly finance cost will be recorded in profit or loss as follows, for the first year:

Dr. Finance cost 432

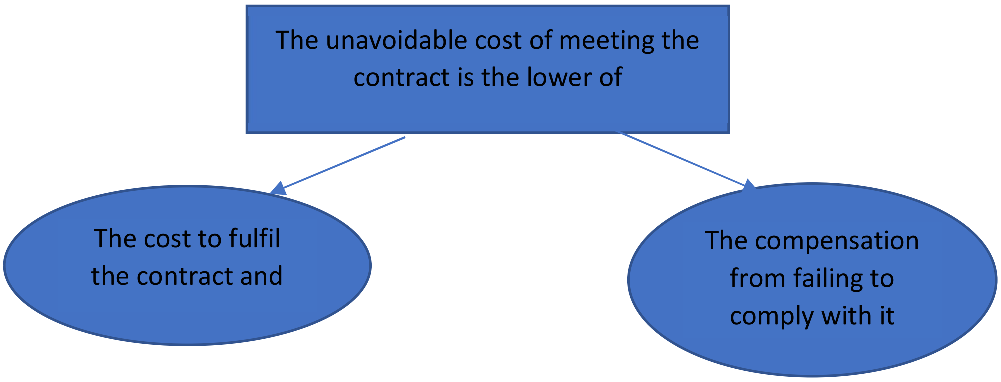
Cr. Decommissioning provisions 432

As such, the amount of the provision increases over time, yearly, until the end of the third year, when it becomes CU10,000. As one may note, this finance cost is not capitalised in the cost of the asset, in accordance with IAS 23 Borrowing costs, as it does not correspond to the definition in that standard.

Provisions are used or released until the relevant final expenditure is made.

Provisions cannot be recorded for future operating losses, as they should be accounted for as an impairment under IAS 36 Impairment of Assets. Other items for which the entity cannot recognise provisions for include maintenance costs or staff training costs. A provision should be recognized, however, for onerous contracts, that is contracts where the unavoidable costs of meeting the contractual obligations exceed the benefits expected to receive under it (see Figure 5).

Figure 5. Unavoidable costs of onerous contracts



Restructuring provisions should only be recognised when the entity has made a formal decision to sell the respective unit, has communicated its decision and has created a valid expectation in the interested parties, to be able to estimate the relevant costs. Simply making the decision to restructure will not lead to the recognition of any provision. Examples of such situations arise from the termination of certain lines of businesses, or fundamental reorganisations of the entity's operations.

Besides provisions and contingent liabilities, entities should also disclose contingent assets in such situations where it might benefit from an inflow of economic benefits resulting from favourable events such as, for example, lawsuits. However, such items should not be recognized as assets on the statement of financial position until such time that they are virtually certain. Contingent assets are possible assets arising from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events that are not within the control of the entity.

DISCLOSURES

For each type of provision (IAS 37.84), entities should disclose 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. Also, entities should disclose the nature and circumstances of each provision, as well as the timing and assumptions around the related outflows. Comparative information is not required.

Entities should also disclose information about each of its contingent liabilities and how likely the possibility of any expenditure arising from them is. 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 organiser of mismanagement. The organiser 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.

The lawsuit is not over by the end of 2022, and the organiser's counsel advises that it might have to pay approximately CU300,000.

In 2023 the lawsuit is over, and the organiser is ordered to pay CU250,000.

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

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 in the notes to its financial statements though , 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

In 2022 the entity must adjust its provision by increasing it to CU300,000 (so an increase of CU200,000), to incorporate the newest piece of information.

Dr. Provision expense 200,000

Cr. Provision for litigation 200,000

Finally, in 2023, when the lawsuit is over, the entity will disburse the final amount that it was ordered to pay, for which it uses part of the provision already recognised (CU250,000), and release the difference (CU50,000).

Dr. Provision for litigation 300,000

Cr. Provision expense 300,000

When the entity will actually pay the compensation that it was sentenced to pay, it will also record a compensation expense through the statement of profit or loss at the same time as the cash out.