



International Financial Reporting Standards

Provisions, Contingent Liabilities and Contingent Assets (IAS 37)

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Scope

- applies to all enterprises in accounting for provisions, contingent liabilities and contingent assets *except* those
 - resulting from financial instruments carried at fair value
 - resulting from executory contracts, unless they are onerous
 - arising in insurance enterprises from insurance contracts
 - covered by another IAS



Definitions used in IAS 37

- provisions are *liabilities* of uncertain timing or amount
- contingent liabilities are:
 - possible obligations to be confirmed by future events not wholly within the control of the enterprise, or
 - present obligations
 - of which the outflow of economic benefits is not probable
 - or which cannot be measured reliably
- contingent assets are possible assets to be confirmed by future events not wholly within the control of the enterprise



Legal or Constructive obligations

- contract
- law / legislation
- established pattern of past practice
- published policies
- creation of a valid expectation



Recognition criteria provisions

- present obligation as a result of a past event
- legal or constructive nature
- probable outflow of economic benefits
- reliably measurable



Recognition criteria asset, liability or contingency?

- asset
 - virtually certain: recognise
- contingent asset
 - probable: disclose
 - possible: do not disclose
 - remote: do not disclose
- liability
 - virtually certain: recognise
 - probable: recognise
- contingent liability
 - probable, but not reliable: disclose
 - possible: disclose
 - remote: do not disclose



Recognition criteria - judgement

- virtually certain: $\geq 90\%$
- probable: $> 50\%$
(more likely than not)
- possible: $\leq 50\%$
- remote: $\leq 10\%$



Derecognition of a provision

- through reversal
 - if an outflow of economic benefits is no longer probable
 - affecting income
- through use
 - only for expenditures for which provision was originally recognised
 - not affecting income



Measurement - a reliability issue

- best estimate
 - weighted average (e.g. warranty provisions), or
 - most likely outcome (e.g. law suit)
- inherent risks and uncertainties to be considered
- discounting required, when effect material
- expected reimbursements (\leq provision) to be recognised as a separate receivable, if virtually certain
- expected gains from disposal of assets should not be recognised as a reduction of the provision or a separate asset



Application - prudence is no longer a virtue!

Do not provide for:

- future operating losses (“rainy days”)
- currency risks
- political risks
- maintenance / refurbishment
- general restructuring projects



Application - warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

- present obligation as a result of a past obligating event: sale
- an outflow of resources embodying economic benefits in settlement: probable
- a provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date



Application - contaminated land - legislation virtually certain to be enacted

An enterprise in the oil industry causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. On e country in which it operates has had no legislation requiring cleaning up, and the enterprise has been contaminating land in that country for several years. At 31 December 2000 it is virtually certain that a draft law requiring clean-up of land already contaminated will be enacted shortly after the year end.

- present obligation as a result of a past obligating event: contamination
- an outflow of resources embodying economic benefits in settlement: probable
- a provision is recognised for the best estimate of the costs of the clean-up



Application - contaminated land and constructive obligation

An enterprise in the oil industry causes contamination and operates in a country where there is no environmental legislation. However, the enterprise has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The enterprise has a record of honouring this published policy.

- present obligation as a result of a past obligating event: contamination
- an outflow of resources embodying economic benefits in settlement: probable
- a provision is recognised for the best estimate of the costs of clean-up



Application - offshore oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10 per cent arise through extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

- present obligation as a result of a past obligating event: construction of the oil rig
- an outflow of resources embodying economic benefits in settlement: probable
- a provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (as part of the cost of the oil rig).



Application - refunds policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

- present obligation as a result of a past obligating event: sale
- an outflow of resources embodying economic benefits in settlement: probable
- a provision is recognised for the best estimate of the costs of refunds



Application - closure of a division - no implementation before balance sheet date

On 12 December the board of an enterprise decided to close down a division. Before the balance sheet date (31 December 2000) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

- present obligation as a result of a past obligating event: none
- no provision is recognised



Application - closure of a division - communication / implementation before balance sheet date

On 12 December the board of an enterprise decided to close down a division making a particular product. On 20 December 2000 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

- present obligation as a result of a past obligating event: communication to customers and employees
- an outflow of resources embodying economic benefits in settlement: probable
- a provision is recognised at 31 December 2000 for the best estimate of the costs of closing the division.



Application - legal requirement to fit smoke filters

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

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

no obligation / no provision

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

no obligation for the costs of fitting smoke filters / obligation to pay fine



Application - staff retraining as a result of changes in the income tax system

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large portion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

- present obligation as a result of a past obligating event: none (no retraining)
- no provision is recognised



Application - onerous contract

An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2000 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

- present obligation as a result of a past obligating event: signing of the lease contract
- an outflow of resources embodying economic benefits in settlement: when the lease contract becomes onerous, probable
- a provision is recognised for the best estimate of the unavoidable lease payments.



Application - a single guarantee

During 1999, enterprise A gives a guarantee of certain borrowings of enterprise B, whose financial condition at that time is sound. During 2000, the financial condition of enterprise B deteriorates and at 30 June 2000 enterprise B files for protection from its creditors.

(a) at 31 December 1999

obligating event: giving guarantee / no outflow probable / no provision

(b) at 31 December 2000

obligating event: giving guarantee / outflow probable / a provision is recognised for the best estimate of the obligation



Application - a court case

After a wedding in 2000, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of authorisation of the financial statements for the year to 31 December 2000 for issue, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year to 31 December 2001, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

- (a) at 31 December 2000: no obligation / no provision
- (b) at 31 December 2001: a provision is recognised for the best estimate of the amount to settle the obligation



Application - refurbishment costs - no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

- present obligation as a result of a past obligating event: none
- no provision is recognised

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.



Application - refurbishment costs - legislative requirement

An airline is required by law to overhaul its aircraft once every three years.

- present obligation as a result of a past obligating event: none
- no provision is recognised

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions for example by selling the aircraft.



Application - costs of modifying existing software

- external events may force an enterprise to modify its software, such as the introduction of EURO or the Y2K issue
- there is no present obligation
- no provision is recognised because the expenditure relates to benefits that have yet to be received
- costs incurred to restore or maintain the existing standard of performance should be recognised as an expense when the restoration or maintenance is carried out



Disclosure - light is the best policeman

By category:

- brief description, timing, uncertainties of provisions
- detailed roll-forward of provisions
- expected and recognised reimbursements relating to provisions
- restructuring provisions recognised in respect of each acquisition (IAS 22)
- brief description and financial effect of any contingent asset and liabilities



Disclosure - roll-forward by category

Opening balances

- + additional provisions made
 - amounts used
 - unused amounts reversed
 - + increase in the discounted amount due to the passage of time and / or changes in the discount rate
 - = ending balances
-
- acquisition provisions are a separate category (IAS 22)
 - change of “title” of provisions prohibited



Disclosure - an exception

- disclosure is not required in the rare circumstances where disclosure would seriously prejudice the position of the enterprise in a dispute with another party
- disclose the general nature of the dispute and the fact that, and reason why, the information has not been disclosed



Identifying provisions: acceptable categories

- provisions for litigation
- provisions for warranties
- provisions for environmental obligations
- provisions for loss orders / onerous contracts
- provisions for work due
- provisions for restructuring costs



Conclusion: little room for accounting arbitrage

- restrictive definition of a provision - event driven
- clear distinction between risks and obligations
- strict rules on restructuring
- roll- forward to be disclosed in the notes



Aim of proposed changes

- Consistent accounting of contingent liabilities in business combinations and outside business combinations
- Clarifying that only present obligations of an entity give rise to liabilities and that liabilities arise from unconditional obligations
- Requiring uncertainty about future events that affect the amount will be required to settle a liability to be reflected in the measurement of the liability
- Explaining that measuring a non-financial liability for a single obligation at its most likely outcome would not necessarily be consistent with the Standard's measurement objective.
- Converging with FAS 146 and FIN 45



Major changes (I): recognition

- Only when liability under the definition of the framework
- Separating obligation (e.g. guarantees) into the *conditional obligation* (e.g. *replacing a faulty product*) and an *unconditional obligation* (e.g. *guarantee of cover*)
- The *unconditional obligation* is frequently a “*stand-ready obligation*” (e.g. “*to stand ready to deliver replacement in case of faulty product*”)
- The *stand-ready obligation* is always a service and meets the criterion of expected outflow of resources
- The *stand-ready obligation* therefore meets the definition of a *liability* and has to be recognised independently of the probability of the conditional obligation



Main changes (II): measurement

- An entity shall measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date.
 - The amount most probable (current IAS 37) would differ normally from this amount
 - Single obligations are measured in accordance with the expected cash flow approach



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