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CHARTERED ACCOUNTANTS OF SRI LANKA

LKAS 37 - Provisions,Contingent Liabilities and Contingent Assets

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Sri Lanka Accounting Standard – LKAS 37

Provisions, Contingent Liabilities and Contingent Assets

Introduction

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
  - Contingent assets

&

- Sufficient information is disclosed in the notes to enable users to understand their;
  - Nature
  - Timing
  - Amount

Provisions and Other liabilities

Provisions

There is uncertainty about;

(i) Timing

OR

(ii) Amount of the future expenditure required in settlement.

Other liabilities

No such uncertainty
E.g.
Trade Payables
Accruals

-Accruals reported as part of Trade & Other payables
-Provisions reported separately

Provisions and contingent liabilities

Provisions

Recognised as liabilities because;

(i) Present obligations

(ii) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligations

Contingent liabilities

Not recognised as liabilities because they are either;

(i) possible obligations, as it has yet to be confirmed whether the entity has a present obligation

OR

(ii) present obligations that do not meet the recognition criteria in this Standard

All provisions are contingent!
Because they are uncertain in timing or amount

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A provision shall be recognised ;

- When an entity has a present obligation (legal or constructive) as a result of a past event;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation;

and

- A reliable estimate can be made of the amount of obligation.

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

No provision is recognised for costs that need to be incurred to operate in the future.

Only those obligations arising from past events existing independently of an entity's future actions are recognised as provisions.

Eg:-
Penalties or clean-up costs for unlawful environmental damage.

Contingent Liabilities/Assets

An entity shall not recognise a contingent Liability/Asset

But

They are disclosed in financial statements.

How to measure a provision?

The amount recognised as a provision shall be the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period.

Eg : An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of LKR 1 million would result. If major defects were detected in all products sold, repair costs of LKR 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75 % of the goods sold will have no defects, 20 % will have minor defects and 5 % will have major defects. Accordingly, the probability of an outflow for the warranty obligations as a whole/ the expected value of the cost of repairs ;

(75% of nil) + (20% of 1m) + (5% of 4m) = LKR 400,000

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Present Value

If the effect of the time value of money is material → Take present value in to consideration

The discount rate shall be a pre-tax rate that reflects **current market assessments** of the time value of money and the **risks specific to the liability** → The discount rate shall not reflect risks for which future cash flow estimates have been adjusted

Future Events

Future events that may affect the amount required to settle an Obligation (arising out of a past action), shall be reflected in the amount of provision where there is sufficient objective evidence that they will occur.

Eg : The effect of possible new legislation is taken into consideration in measuring an existing obligation, when sufficient objective evidence exists that the legislation is virtually certain to be enacted.

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Reimbursement

If expenditure required to settle a provision is expected to be reimbursed;

- Recognised when, and only when, it is certain that reimbursement will be received
- The reimbursement shall be treated as a separate asset
- The amount recognised for the reimbursement shall not exceed the amount of the provision

Further,

Gains from expected disposal of assets	shall not be taken into account
No provision is recognised for	Future operating losses

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Changes in Provisions

Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate

Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time.

This increase is recognised as borrowing cost

A provision shall be used only for expenditures for which the provision was originally recognised

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.

If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

Restructuring

Here are some examples of events;

- Sale or termination of a line of business.
- Changes in management structure, eliminating a layer of management.
- Fundamental re-organisations that have a material effect on the nature and focus of the entity's operations.

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Restructuring Contd;

A constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least:

(i) the business or part of a business concerned;
(ii) the principal locations affected;
(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
(iv) the expenditures that will be undertaken; and
(v) when the plan will be implemented; and

(**b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.**

A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met.

Restructuring Contd;

A management or board decision to restructure taken before the end of the reporting period does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period:

(a) started to implement the restructuring plan; or

(b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

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Restructuring Contd;

- If an entity starts to implement a restructuring plan, or
- Announces its main features to those affected, only after the reporting period,
- If the restructuring is material and
- Non-disclosure could influence the economic decisions that users make on the basis of the financial statements

Disclosure is required under LKAS 10 Events after the Reporting Period

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Restructuring Contd;

- No obligation arises for the sale of an operation until the entity is committed to the sale, i.e. there is a binding sale agreement.
- A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring;

and

(b) not associated with the ongoing activities of the entity.

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What to disclose in Financial Statements?

1. The carrying amount at the beginning and end of the period
2. Additional provisions made in the period
3. Amounts incurred and charged against the provision
4. Unused amounts reversed during the period
5. The effect of any change in the discount rate

Comparative information <u>not required</u>

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Overview - Provisions & Contingent Liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of:
(a) a present obligation; or
(b) a possible obligation 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.

There is a present obligation that probably requires an outflow of resources.	There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.	There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.
A provision is recognised	No provision is recognised	No provision is recognised
Disclosures are required for the provision	Disclosures are required for the contingent liability	No disclosure is required

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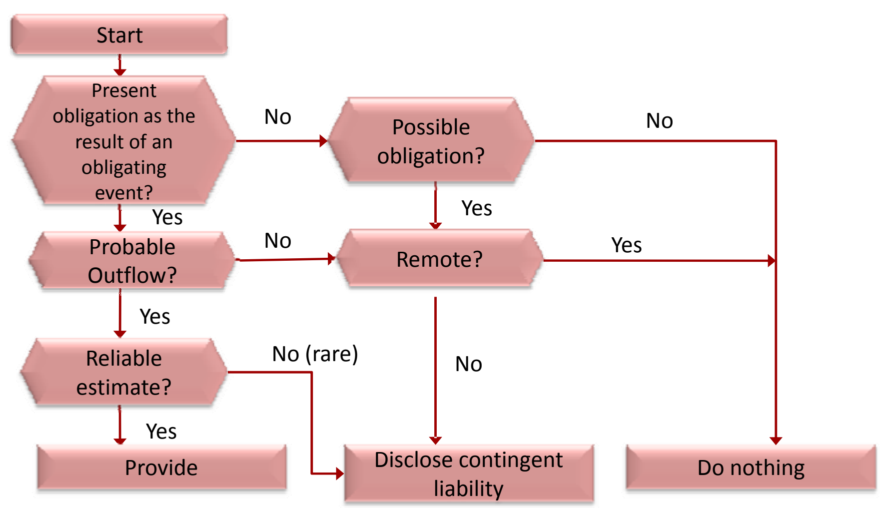
Overview - Provisions & Contingent Liabilities



Recognition – Example 1

1. 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.

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Answer- example 1

1. Refunds policy:

Present obligation as a result of a past obligating event – The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund purchases.

An outflow of resources embodying economic benefits in settlement – Probable, a proportion of goods are returned for refund.

Conclusion – A provision is recognised for the best estimate of the costs of refunds.

Recognition – Example 2A

2A. Closure of a division – no implementation before end of the reporting period

On 12 December 20X0 the board of an entity decided to close down a division. Before the end of the reporting period (31 December 20X0) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

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Answer- example 2A

2A. Closure of a division – no implementation before end of the reporting period

Present obligation as a result of a past obligating event – has been no obligating event and so there is no obligation.

Conclusion – No provision is recognised. Disclosure required.

Recognition – Example 2B

2B. Closure of a division – communication/ implementation before end of the reporting period

On 12 December 20X0, the board of an entity decided to close down a division making a particular product. On 20 December 20X0 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.

Answer- example 2B

2B. Closure of a division – communication/ implementation before end of the reporting period

Present obligation as a result of a past obligating event – The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement – Probable

Conclusion – A provision is recognised at 31 December 20X0 for the best estimate of the costs of closing the division.

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Recognition – Example 3

3. 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 entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff (or a confirmed plan to retrain)has taken place.

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Answer- example 3

3. Staff retraining as a result of changes in the income tax system

Present obligation as a result of a past obligating event :
There is no obligation because no obligating event (retraining) has taken place.

Conclusion :
No provision is recognised

Disclosure – Example

1. Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the end of the reporting period, a provision of LKR 60,000 has been recognised. The provision has not been discounted as the effect of discounting is not material. The following information is disclosed:

A provision of LKR 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years after the reporting period.

QUESTIONS??

Thank you.

Presenter details;

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