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## LKAS 37

### Provisions and Contingencies

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## LKAS 37: Overview

- ◆ Objective
- ◆ Scope
- ◆ Definitions
- ◆ Recognition
- ◆ Measurement
- ◆ Application of the recognition and measurement rules
- ◆ Contingent liabilities and contingent assets
- ◆ Disclosure

## LKAS 37: Objective

- ◆ Ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets
- ◆ Disclose sufficient information in the notes to enable users to understand their nature, timing and amount



## Scope

◆ **Covers all provisions, contingent liabilities and assets, except**

- ◆ Those resulting from executory contracts\*
  - ◇ Contracts where neither party has performed any obligations
- ◆ Those covered by another Standard

◆ **Does not apply to financial instruments within scope of LKAS 39/SLFRS 9**

*\* except where onerous*



## Scope

◆ **Examples of other Standards that deal with a specific type of provision, contingent liability or asset**

- ◆ **LKAS 11** Construction Contracts
- ◆ **LKAS 12** Income Taxes
- ◆ **LKAS 17** Leases (except onerous operating leases)
- ◆ **LKAS 19** Employee Benefits
- ◆ **SLFRS 4** Insurance Contracts



## Definitions

### ◆ Liability

- ◆ Present obligation arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits

### ◆ Provision

- ◆ Liability of uncertain timing or amount

### ◆ Obligating event

- ◆ Event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation



## Definitions – Commentary

### ◆ Provisions are recognised liabilities

- ◆ Degree of uncertainty about timing and amount distinguishes provisions from liabilities such as
  - ◇ Trade and other payables
  - ◇ Accruals
- ◆ Provisions must be presented as a line item on the face of the statement of financial position
  - ◇ Split between current and non-current
- ◆ Examples include provisions for restructuring costs, decommissioning/asset retirement and environmental costs



## Definitions

### ◆ Contingent liability

- ◆ Possible obligation that arises from past events whose existence will only be confirmed by uncertain future events not wholly within the control of the entity, or
- ◆ Present obligation that arises from a past event but is not recognised because:
  - ◇ It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or
  - ◇ Amount cannot be measured with sufficient reliability



## Definitions – Commentary

### ◆ Contingent liabilities are not recognised liabilities

- ◆ Not included in the numbers reported in the statement of financial position
- ◆ Disclosed in the notes to the financial statements, unless the possibility of an outflow of resources is considered to be remote
- ◆ Examples include legal cases outstanding and obligations under guarantees



## Definitions

### ◆ Contingent asset

- ◆ Possible asset that arises from past events and whose existence will only be confirmed by uncertain future events not wholly within the control of the entity

### ◆ Contingent assets are not recognised assets

- ◆ Risk of recognising an asset that may never be realised

### ◆ Examples include recoveries under insurance claims and legal actions

- ◆ Assets of this nature can only be recognised where realisation is 'virtually certain'
- ◆ Disclose where inflow of economic benefits is probable

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## Provisions – Recognition Criteria

### ◆ A provision shall be recognised when:

- a) Present obligation (legal or constructive) exists as a result of a past event
- b) Probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
- c) Amount of obligation can be estimated reliably

### ◆ No provision may be recognised unless all three conditions are met

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## Present Obligation

◆ **Can arise from a legal or constructive obligation**

◆ **Legal obligation derives from:**

- ◆ A contract
- ◆ Legislation, or
- ◆ Other operation of law

◆ **Examples of legal obligations**

- ◆ License requirement to remove oilrig and restore seabed
- ◆ Legislation enacted to require past environmental damage to be put right
- ◆ Warranties given by manufacturer

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## Present Obligation

◆ **Constructive obligations arise from entity's actions where:**

- ◆ By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and
- ◆ Entity has created valid expectation on the part of those other parties that it will discharge those responsibilities

◆ **Examples of constructive obligations**

- ◆ Restructuring programme
- ◆ Retailer's refunds policy
- ◆ Environmental policy

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## Past Events

### ◆ Obligating event

- ◆ Event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation
- ◆ Must have a past event – trigger for obligation

### ◆ Examples

- ◇ Sale of goods for warranty liability
- ◇ Contamination of land for environmental obligation
- ◇ Construction of power station for decommissioning liability
- ◆ Can happen over time
  - ◇ Strip mining

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## Probable Outflow to Settle

### ◆ Must determine whether it is probable that an outflow of resources will be required to settle the obligation

- ◆ Probable in this context is defined as **'more likely than not'**
- ◆ If probability not more than 50%, must not provide – disclose a contingent liability

### ◆ Proposed amendments to LKAS 37 suggested that probability of outflow should only affect the measurement of liability

- ◆ Under LKAS 37, if there is a 40% probability of making a payment of CU10,000, no provision can be recognised
- ◆ ED proposed that a provision would be recognised and the degree of probability would be reflected in measuring the amount to be recognised
- ◆ Project has been postponed; no date for revisiting it

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## Probable Outflow to Settle

- ◆ **Assess probability of outflow for class as a whole where there are a number of similar obligations – for example, obligations under product warranties**
  - ◆ Not probable that sale to a particular customer will require outflow, but
  - ◆ For class as a whole, there is a probable outflow

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## Measurement

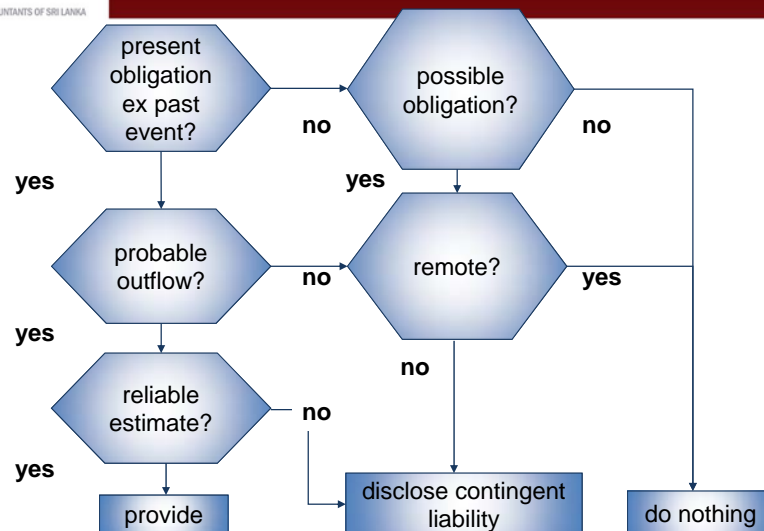
- ◆ **Example**
  - ◆ Goods are sold with a warranty offering free repairs if a defect becomes apparent within six months of purchase
  - ◆ If minor defects arose in all products, repairs would cost CU1m If major defects arose in all products, repair costs of CU4m would be incurred
  - ◆ Past experience and expectations suggest that 75% of goods will have no defects, 20% will have minor defects and 5% will have major defects
  - ◆ Expected value of cost of repairs is:  
 $(75\% \text{ of nil}) + (20\% \text{ of CU1m}) + (5\% \text{ of CU4m}) = \text{CU400,000}$

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## Reliable Estimate of Obligation

- ◆ LKAS 37 considers that the entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision
  - ◆ Use estimation techniques
- ◆ In extremely rare cases where no reliable estimate can be made, disclose as a contingent liability
  - ◆ No further guidance

## LKAS 37 – Recognition Criteria





## Measurement

- ◆ **Measure at 'best estimate' of amount required to settle the present obligation at end of the reporting period**
  - ◆ Amount that entity would rationally pay to settle or to transfer to third party – exit value
  - ◆ Not often possible to settle or transfer in this way
- ◆ **Judgement by preparers – assisted by experience of similar transactions and experts**
- ◆ **In measuring – can take into account evidence from events after the reporting period**

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## Measurement

- ◆ **Need estimation techniques if do not wish to settle and there is no market in obligations**
- ◆ **If all possible outcomes and their probabilities can be specified, what methods are there?**
  - ◆ Most likely outcome (highest probability) – ignores all others; could imply no obligation
  - ◆ Maximum amount (highest possible) – could overstate if remote
  - ◆ At least the minimum amount (lowest possible) – could understate
  - ◆ Expected value

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## Measurement

### ◆ Most likely outcome?

- ◆ LKAS 37 states that the individual most likely outcome may be the best estimate when measuring a single obligation
- ◆ However it points out that, where other possible outcomes are mostly higher or lower than the most likely outcome, the best estimate will be a higher or lower amount

### ◆ Expected value?

- ◆ Takes into account all possible outcomes
- ◆ Weighted by their associated probabilities
- ◆ Works best for large population of similar claims
  - ◇ See earlier example re product warranties

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## Measurement

### ◆ Risks and uncertainties are taken into account in reaching best estimate

- ◆ Adjusting for risk may increase amount recognised
- ◆ Does not justify excessive provisioning or deliberate overstatement
- ◆ Beware double-counting for risk
- ◆ Aim to be neutral/realistic

### ◆ Must indicate uncertainties re amount and timing

- ◆ Disclosure requirement

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## Measurement – Present Value

◆ **Measure provision at present value where the effect of the time value of money is material**

- ◆ Not necessary for short-term provisions – due in less than one year?
- ◆ Discount rate should be a pre-tax rate that
  - ◇ Reflects time value of money and risks specific to liability

◆ **Not much guidance re arriving at discount rate**

- ◆ Inflation
- ◆ Risks and uncertainties
- ◆ Tax

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## Measurement

◆ **Must review provisions at each reporting date and adjust to reflect current best estimate**

- ◆ Might mean reversal
- ◆ Where discounting is used, the carrying amount of liability increases with passage of time – also known as ‘unwinding’ of the discounting (or ‘accretion’ in the US)
  - ◇ Debit profit or loss – finance cost
  - ◇ Credit liabilities
- ◆ Provision might also require adjustment for:
  - ◇ Change in estimate of amount or timing of cash flows, and/or
  - ◇ Change in discount rate

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## Measurement

- ◆ **LKAS 37 does not give guidance about treatment of changes in estimates or discount rate, but**
  - ◆ IFRIC 1 covers in context of *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, and
  - ◆ By analogy IFRIC 1 is usually applied to other provisions
- ◆ **Where estimates or discount rates change**
  - ◆ Change in provision is either reflected in related asset or as operating item in profit or loss
- ◆ **Cash flows in settlement of obligation are reflected in the provision**
- ◆ **Can only use provision to charge expenditure for which provision was originally established**

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## Reimbursements

- ◆ **Effect of expected reimbursement (e.g. insurance recovery)**
  - ◆ Recognise only when virtually certain to be received
  - ◆ Amount should not exceed amount of provision
  - ◆ Recognise reimbursement as separate asset (receivable) in statement of financial position
  - ◆ May present provision expense net of reimbursement in profit or loss

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## Application – Onerous Contracts

◆ **The present obligation under an onerous contract shall be recognised and measured as a provision**

- ◆ Arises when 'unavoidable costs of meeting obligations under the contract exceed the economic benefits expected to be received under it'
  - ◇ Unavoidable costs reflect the least net cost of exiting from the contract, defined as the lower of the costs of fulfilling it and any compensation or penalties arising if not fulfilled
- ◆ Operating leases on vacant premises are examples
  - ◇ If premises are occupied, the lease is not onerous because the economic benefits are represented by using the property in the business
  - ◇ When vacated, the only economic benefits are potential subletting income

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## Restructuring Provisions

◆ **Restructuring = programme planned and controlled by management that materially changes either:**

- ◆ Scope of business, or
- ◆ Manner of conducting business

◆ **Examples include:**

- ◆ Sale or termination of line of business
- ◆ Closure/relocation from country/region
- ◆ Changes in management structure – eliminating layer of management, and
- ◆ Fundamental reorganisations having a material effect on nature and focus of operations

◆ **Recognise provision only when general recognition criteria are met – LKAS 37 interprets for restructurings**

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## Restructuring Provisions

◆ **Constructive obligation to restructure arises only when**

**a) Entity has a detailed formal plan identifying at least:**

- ◇ Business or part of a business involved
- ◇ Principal locations affected
- ◇ Location, function, number of employees who will be compensated for termination
- ◇ Expenditures that will be undertaken, and
- ◇ When the plan will be implemented, and

**b) Has raised a valid expectation that plan will be carried out – either announcement of main features or implementation started**

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## Restructuring Provisions

◆ **May include only direct expenditures, those that are both:**

- ◆ Necessarily entailed by the restructuring, and
- ◆ Not associated with on-going activities of the entity

◆ **Restructuring provision cannot include such costs as:**

- ◆ Retraining or relocating continuing staff
- ◆ Marketing, or
- ◆ Investment in new systems or distribution networks
  - ◇ These relate to the future conduct of business; must be recognised as if independent of the restructuring

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## Provisions – Disclosures

### ◆ For each class of provision, disclose

- ◆ Carrying amount at beginning and end of period
- ◆ Additional provisions made in period
- ◆ Amounts used during the period
- ◆ Unused amounts reversed during the period
- ◆ Increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate
- ◆ Description of obligation
- ◆ Indication of uncertainties
- ◆ Amount of any expected reimbursement

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## Provisions – Disclosures

### ◆ Do not have to disclose changes for comparative period – explicitly stated in LKAS 37

### ◆ In addition

- ◆ Brief description of nature of obligation and expected timing of any outflows
- ◆ Indication of uncertainties re amount or timing of outflows. Might require disclosure of major assumptions re future events
- ◆ Amount of any expected reimbursement, stating amount of any asset recognised

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## Contingent Liabilities

### Definition

- ◆ Possible obligation that arises from a past event whose existence will only be confirmed by uncertain future events not wholly within entity's control, or
- ◆ Present obligation that arises from a past event but is not recognised because
  - ◇ Economic outflow is not probable, or
  - ◇ Amount cannot be reliably measured

### Recognition

- ◆ Do not recognise a contingent liability
- ◆ Disclose unless possibility of outflow is remote

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## Contingent Assets

### Definition

- ◆ Possible asset that arises from a past event and whose existence will only be confirmed by uncertain future events not wholly within the entity's control

### Examples

- ◆ Insurance claims, legal actions

### Recognition

- ◆ Do not recognise a contingent asset – may result in recognising income that may never be realised
  - ◇ An asset can only be recognised where realisation is 'virtually certain'
- ◆ Disclose where inflow is probable

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## Contingent Liability/ Asset Recognition Summary

Likelihood	Accounting Treatment	
	Contingent Liability	Contingent Asset
Virtually Certain	Not contingent Recognise a provision	Not contingent Recognise asset
Probable	Not contingent Recognise a provision	Contingent Disclose
Possible	Contingent Disclose	No disclosure
Remote possibility	No disclosure	

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## Contingent Liabilities – Disclosures

- ◆ A brief description of nature of contingent liability for each class and, where practicable
  - ◆ Estimate of its financial effect
  - ◆ Indication of uncertainties related to amount or timing of any outflow
  - ◆ Possibility of reimbursement

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## Contingent Assets – Disclosures

- ◆ A brief description of nature of the contingent asset and, where practicable an estimate of its financial effect
- ◆ Avoid giving misleading indications that may overstate the probability or amount of income

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## Disclosure

- ◆ **For all disclosures**
  - ◆ If any information not disclosed because impracticable, disclose that fact
  - ◆ In extremely rare cases need not disclose the information but should disclose general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed
    - ◇ Expected to prejudice seriously position of the entity in a dispute with other parties

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# THANK YOU