PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS: IAS 37

Definitions

- A **legal obligation** is an obligation that derives from: a contract, legislation, or other operation of law
- **A constructive obligation** is an obligation that derives from an 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
  - as a result, the entity has created a **valid expectation** on the part of those other parties that it will **discharge those responsibilities**

Provisions

- **Provision** = a liability of uncertain timing or amount
- A provision shall be recognised when:
  - (a) an entity has a **present obligation** (legal or constructive) as a result of a past event; and
  - (b) it is **probable** that an outflow of resources will be required to settle the obligation; and
  - (c) a **reliable estimate can be made of the amount** of the obligation
- probable = more likely than not (greater than 50% chance of happening)
- if any one of these criteria are not met, it is considered a "contingent liability" and is disclosed

Present obligation

- If it is not clear whether there is a present obligation
  - a past event is deemed to give rise to a present obligation if it is **more likely than not** that a present obligation exists at the end of the reporting period

Past event

- A past event that leads to a present obligation is called an **obligating event**
- For an event to be an obligating event, it is necessary that the entity has no **realistic alternative** to settling the obligation created by the event. This is the case only:
  - (a) where the settlement of the obligation can be enforced by law; or
  - (b) in the case of a constructive obligation, where the event creates valid expectations in other parties that the entity will discharge the obligation.

Measurement

- A provision is recognized at the **best estimate** of the amount required to settle the present obligation at the end of the reporting period
- Where the provision being measured involves a **large population of outcomes**, the obligation is estimated by using **expected value.**
- Where there is a continuous **range of possible outcomes**, **and each point in that range is as likely as any other**, the **mid-point** of the range is used
  - If one point is more likely, then that point becomes the best estimate
- Provisions are measured before tax

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
  - a **present obligation** that arises from past events but is not recognised because:
    (a) it is **not probable** that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    (b) the amount of the obligation **cannot be measured** with sufficient reliability
- An entity shall not recognise a contingent liability
- a contingent liability is **disclosed** unless the possibility of an outflow of resources embodying economic benefits is remote

Contingent assets

- **contingent asset** = possible asset 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
- example is a claim that an entity is pursuing through legal processes, and the outcome is uncertain
- contingent assets are **not recognized**
- A contingent asset is **disclosed**, if the inflow of economic benefits is **probable**
- Contingent assets are continually assessed, and if the inflow of economic benefits become **virtually certain,** it is no longer considered a "contingent asset" and it is recognized as an asset

Reimbursements

- Where the amount required to settle a provision is expected to be reimbursed by another party, the reimbursement is recognised when it is **virtually certain** that reimbursement will be received
- The reimbursement shall be treated as a **separate asset on the balance sheet** (cannot offset)
- The amount recognised for the reimbursement **shall not exceed the amount of the provision**
- the **expense** relating to a provision may be **presented net** of the amount recognised for a reimbursement

Changes in provisions

- provisions need to be reviewed at the end of every reporting period, if needed, it should be adjusted to reflect the current best estimate (done prospectively)
- if no longer a provision (per the definition), it should be reversed

Application of the recognition and measurement rules

Onerous contracts

- **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
- i.e. you are going to lose money on this contract no matter what
- the present obligation under the contract shall be recognised and measured as a provision (the debit entry is a loss)
- **provision set up** = net cost = unavoidable cost – economic benefits
- the unavoidable cost of meeting the obligation is the **lesser of:**
  (a) cost of fulfilling the contract
  (b) penalties from failing to fulfill the contract

Restructuring

- A restructuring is a program that is planned and controlled by management, and materially changes either:
    - (a) the scope of a business undertaken by an entity; or
    - (b) the manner in which that business is conducted.
- The following are examples of restructuring:
    1. sale or termination of a line of business;
    2. closing or relocating business locations
    3. changing management structure, for example, eliminating a layer of management
- recognize a **provision** when the following **two** criteria are met:
    1. the entity has a **detailed formal plan** for the restructuring identifying **at least**:
        - the **business** or part of a business concerned;
        - the **principal locations** affected;
        - the location, function, and approximate number of **employees who will be compensated** for terminating their services;
        - the **expenditures** that will be undertaken; and
        - **when** the plan will be implemented; and
    2. has **raised a valid expectation** in those affected that it will carry out the restructuring by:
        - (a) **starting to implement** that plan; or
        - (b) **announcing its main features to those affected by it**.
- When both criteria are met, it is deemed to be a constructive obligation, and a provision is set up
- 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.

Decommissioning or Restoration Liability (Asset Retirement Obligations)

- Similar to asset retirement obligation covered under ASPE 3110
- Decommissioning/restoration is recognized as a
    - Liability (per IAS 37 – provisions); and
    - As part of Property, Plant and Equipment (IAS 16)
- Reduction in liability due to passage of time (i.e. discounting) is recognized as **"interest expense"**
- A liability can occur from legal obligations or constructive obligations

Comparison to ASPE

- contingencies is covered under **ASPE section 3290 – Contingencies**
- under ASPE, the term **provision** is not used; instead the term **contingent liability** is used, even where an amount is recognized as a liability
- under ASPE, the concept of **constructive obligation** does not apply
- under ASPE a contingent liability is recognized when probability of loss is **likely** (rather than probable); threshold for IFRS is lower
- under ASPE, when there is a **range and no best estimate**, take minimum amount
- under ASPE, no need to **review contingent liability @** end of every period
- under ASPE, contingent assets are disclosed when **likely** to be realized
- under ASPE, no detailed guidance on **Restructuring** – since constructive obligation doesn't apply, we would likely recognize it when there is a legal obligation
- Under ASPE, **onerous contracts and reimbursements** are not covered