ACCOUNTING SUMMARY 2017 - 07

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Objective

This Standard sets out the required accounting treatment and disclosures for provisions, contingent liabilities and contingent assets. These are linked by their commonality as areas that require judgment at the end of an accounting period. In all three cases, the correct treatment in terms of making accounting adjustments or making disclosure (or ignoring altogether) comes down to careful examination of the definitions therein.

Scope

This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:

(a) those resulting from executory contracts, except where the contract is onerous; and
(b) those covered by another Standard.

When another Standard deal with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard.

For example, some types of provisions are addressed in Standards on:

- Construction contracts (see IFRS 15 *Revenue from Customer Contracts*);
- Income taxes (see IAS 12 *Income Taxes*);
- Leases (see IAS 17 *Leases*). However, as IAS 17 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases;
- Employee benefits (see IAS 19 *Employee Benefits*);
- Insurance contracts (see IFRS 4 *Insurance Contracts*). However, this Standard applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of IFRS 4; and
- Contingent consideration of an acquirer in a business combination (see IFRS 3 *Business Combinations*).

Effective date

This Standard becomes operative for annual financial statements covering periods beginning on or after 1 July 1999. Earlier application is encouraged.

Defined terms

A liability is a present obligation of the entity arising from past events which is expected to be settled by the outflow of economic benefits.

A provision is a liability of uncertain timing or amount.

A contingent asset is a 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.

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An *obligating event* gives rise to a present obligation. This Standard sets out the following guidance on the identification of obligating events, the salient features of which include:

- A present obligation exists where the entity has no realistic alternative but to make the transfer of economic benefits; or
- A present obligation may take the form of a legal obligation if, and only if, settlement of the obligation can be enforced by the law; or
- A present obligation may take the form of a constructive obligation.

A constructive obligation is an obligation that derives from an entity's actions where:

- The entity has indicated to other parties (by a pattern of past practice, published policies or a current statement) that it will accept certain responsibilities; and
- As a result, the entity has created in the other parties a valid expectation it will discharge those responsibilities.

A contingent liability either a:

- possible obligation arising from past events whose existence will be confirmed only by the occurrence or non-occurrence of some uncertain future event not wholly within the entity's control, or
- present obligation that arises from a past event but is not recognized because either:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or
  (ii) the amount of the obligation cannot be measured with sufficient reliability.

Specific applications

No provision should be made for future operating losses, including those relating to a restructuring, as they do not meet the definition of a liability at the end of the financial reporting period.

Provisions should be made for onerous contracts, being contracts where the unavoidable future costs under the contract exceed the expected future economic benefits (e.g. a leased property sub-let at a lower rent).

A restructuring is a sale or termination of a line of business, closure of business locations, changes in management structure or a fundamental re-organisation of the company.

No obligation arises for the sale of an operation until there is a binding sale agreement.

A provision for restructuring costs is recognised only when the general recognition criteria are met. More specifically, a constructive obligation only arises when a detailed formal plan is in place and it has begun or been announced to those affected by it. A board decision is not enough. Restructuring provisions should include only direct expenditures caused by the restructuring, not costs that associated with the ongoing activities of the entity.

Recognition

An entity must recognise a provision if, and only if:

(a) a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event);
(b) an outflow of economic benefit to settle the obligation is probable ("more likely than not"); and
(c) the amount of the obligation can be estimated reliably.

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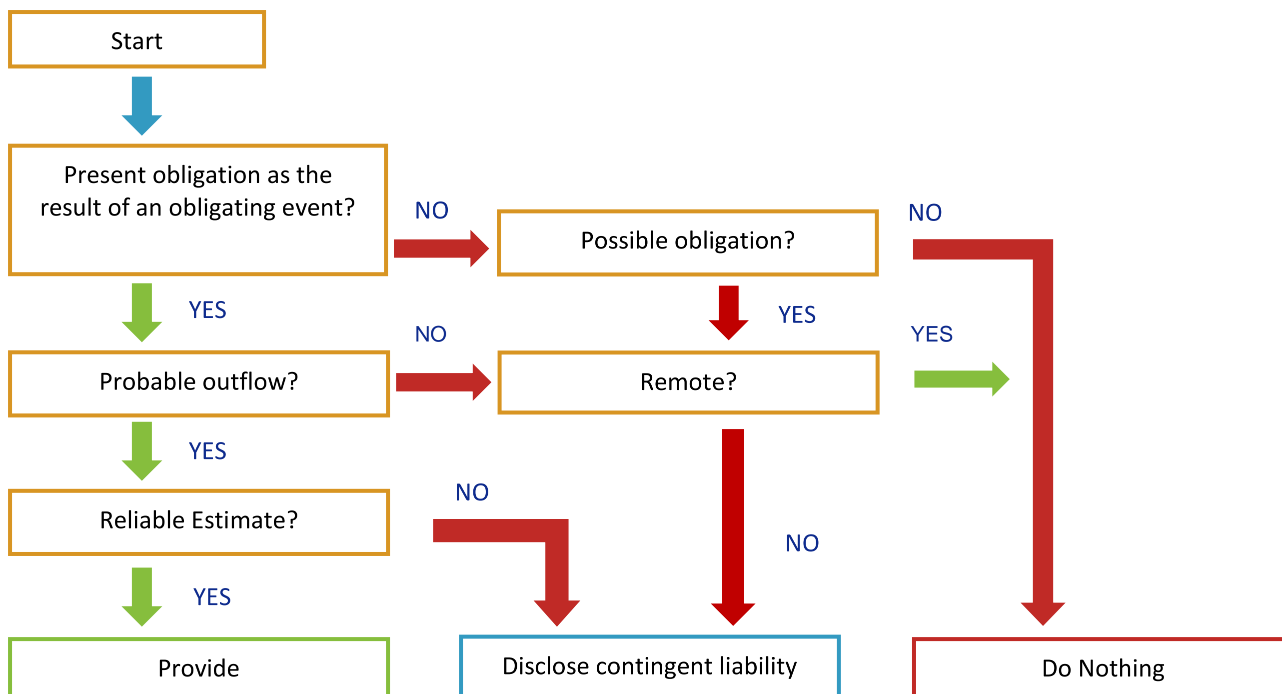
A contingent liability, being a possible obligation, is not recognised but is disclosed unless the possibility of an outflow of economic benefits is remote.

A contingent asset should not be recognised but should be disclosed where an inflow of economic benefits is probable.

Decision tree

The purpose of this diagram is to summarise the main recognition requirements of the Standard for provisions and contingent liabilities.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the financial reporting period.

Measurement

Best estimate	The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the financial reporting date, that is, the amount that an entity would rationally pay to settle the obligation at the end of the financial reporting period or to transfer it to a third party. The estimate is made by the management of the entity but in light of all available evidence, including that received after the end of the financial reporting date, and may be supplemented by the evidence of independent experts.

Present value	When reimbursement of the amounts provided for is virtually certain (e.g. under an insurance contract), a separate asset should be recognised. In the statement of comprehensive income, the expense relating to the provision and the amount recognised as a reimbursement may be shown net. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.
Reimbursement	Where the effect of the time value of money is material, the provisions should be discounted using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the liability.
Changes in provisions	Provisions must be reviewed at each financial reporting date and the amount adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.
Future events	Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.
Risks and uncertainties	The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision
Use of provision	A provision shall be used only for expenditures for which the provision was originally recognised.

Presentation and disclosure

An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of provisions and the disclosure of contingent liabilities and contingent assets:

In the Notes to the financial statement:

(a) For each class of provision, an entity shall disclose:

- (i) the carrying amount at the beginning and end of the period;
- (ii) additional provisions made in the period, including increases to existing provisions;
- (iii) amounts used (i.e. incurred and charged against the provision) during the period;
- (iv) unused amounts reversed during the period; and
- (v) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

(b) Comparative information is not required.

(c) An entity shall disclose the following for each class of provision:

- (i) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- (ii) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
- (iii) the amount of any expected reimbursement, stating the amount of any asset that has been recognised

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In the Notes to the financial statement:

(d) Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the financial reporting period a brief description of the nature of the contingent liability and, where practicable:

  (i) an estimate of its financial effect;
  (ii) an indication of the uncertainties relating to the amount or timing of any outflow; and
  (iii) the possibility of any reimbursement.

(e) Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the financial reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions.

(f) Where any of the information required is not disclosed because it is not practicable to do so, that fact shall be stated.

(g) In extremely rare cases, disclosure of some or all of the information can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.