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IFRS Foundation: Training Material for the *IFRS<sup>®</sup> for SMEs*

# Module 21 – Provisions and Contingencies



# **IFRS Foundation: Training Material for the *IFRS<sup>®</sup> for SMEs***

including the full text of  
Section 21 *Provisions and Contingencies*  
of the International Financial Reporting Standard (IFRS)  
for Small and Medium-sized Entities (SMEs)  
issued by the International Accounting Standards Board on 9 July 2009

*with extensive explanations, self-assessment questions and case studies*

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# Module 21 – Provisions and Contingencies

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB). The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the *International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

## INTRODUCTION

This module focuses on the accounting and reporting of provisions and contingencies in accordance with Section 21 *Provisions and Contingencies* of the *IFRS for SMEs*. It introduces the learner to the subject, guides the learner through the official text, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in accounting for provisions, contingent liabilities and contingent assets. Furthermore, the module includes questions designed to test the learner's knowledge of the requirements and case studies to develop the learner's ability to account for provisions, contingent liabilities and contingent assets in accordance with the *IFRS for SMEs*.

### Learning objectives

Upon successful completion of this module you should know the financial reporting requirements for provisions and contingencies in accordance with the *IFRS for SMEs*. Furthermore, through the completion of case studies that simulate aspects of the real world application of that knowledge, you should have enhanced your ability to account for provisions, contingent liabilities and contingent assets in accordance with the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*, be able:

- to distinguish provisions from other liabilities of an entity and determine which provisions should be accounted for in accordance with Section 21
- to identify when provisions should be recognised in financial statements
- to measure provisions on initial recognition and subsequently
- to present and disclose provisions in financial statements
- to identify, estimate the financial effect of and disclose contingent liabilities and contingent assets in financial statements
- to demonstrate an understanding of the significant judgements that are required in accounting for and reporting provisions, contingent liabilities and contingent assets.

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## **IFRS for SMEs**

The *IFRS for SMEs* is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* includes mandatory requirements and other material (non-mandatory) that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority.
- implementation guidance that includes illustrative financial statements and a disclosure checklist.
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*.
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue*. Those appendices are non-mandatory guidance.

## **Introduction to the requirements**

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. The objective of Section 21 is to prescribe criteria for accounting for provisions, contingent liabilities and contingent assets, and to require disclosures in the notes to financial statements to enable users to understand their nature, timing and amount.

Provisions are a subset of liabilities. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. A provision is a liability of uncertain timing or amount. Examples of provisions include liabilities for warranties, lawsuits, customer refunds, onerous (loss-making) contracts, and plant closures and restructurings.

A provision is recognised only when a past event has created a present obligation, an outflow of resources is probable, and the amount of the obligation can be estimated reliably. Provisions are measured at the best estimate of the amount required to settle the obligation at the reporting date, and specified disclosures shall be given (see chart 1 below).

Note: An accrual that is allowed for local income tax or other regulatory purposes is not necessarily the same as an expense or liability to be recognised for financial reporting purposes.

A contingent liability arises when (a) there is a possible obligation that arises from past events 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 (b) there is a present obligation that arises from past events but either it is not probable that an outflow of

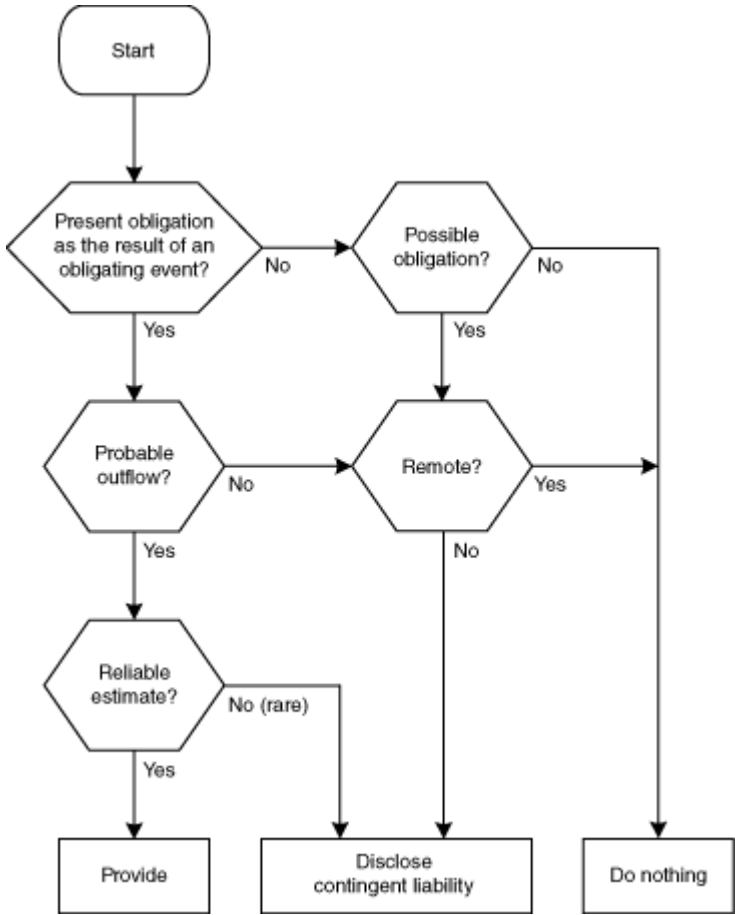
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resources embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

Except for contingent liabilities of an acquiree in a business combination (see paragraph 21.12) contingent liabilities are not recognised in the statement of financial position. However, in specified circumstances, they are disclosed in the notes (see chart 1 below).

In other words, this section classifies obligations into two categories—provisions and contingent liabilities. Those that meet the liability recognition criteria are classified as provisions. Those that do not meet the recognition criteria are classified as contingent liabilities. Contingent liabilities also include possible obligations. Possible obligations do not meet the definition of a liability. The classification of obligations is important because provisions are recognised in the entity’s statement of financial position whereas contingent liabilities are not recognised.

**CHART 1 - DECISION TREE**



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. Contingent assets are not recognised in the statement of financial position. However, in specified circumstances, they are disclosed in the notes.

In extremely rare cases, disclosure of some or all of the information required about provisions,

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contingent liabilities and contingent assets can be expected to prejudice seriously the position of the entity in a dispute. In such cases, an entity is permitted to make specified alternative disclosures. However, no relief is provided from the recognition and measurement requirements for provisions (ie the entity is required to recognise the provision and measure it at the best estimate of the amount required to settle the obligation at the reporting date).

Other requirements apply to the recognition and measurement of contingent liabilities of an acquiree in a business combination (see paragraph 21.12).



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## REQUIREMENTS AND EXAMPLES

The contents of the Section 21 *Provisions and Contingencies* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary of the *IFRS for SMEs* are also part of the requirements. They are in **bold type** the first time they appear in the text of Section 21. The notes and examples inserted by the IFRS Foundation education staff are not shaded. Other annotations inserted by the IFRS Foundation staff are presented within square brackets in **bold italics**. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

### Scope of this section

- 21.1 This section applies to all **provisions** (ie liabilities of uncertain timing or amount), **contingent liabilities** and **contingent assets** except those provisions covered by other sections of this IFRS. These include provisions relating to:
- (a) leases (Section 20 *Leases*). However, this section deals with operating leases that have become onerous.
  - (b) construction contracts (Section 23 *Revenue*).
  - (c) employee benefit obligations (Section 28 *Employee Benefits*).
  - (d) income tax (Section 29 *Income Tax*).

### Notes

The requirements of this section do not apply to financial liabilities. Financial liabilities are accounted for in accordance with the requirements of Section 11 *Basic Financial Instruments*.

Section 19 *Business Combinations and Goodwill* addresses the treatment by an acquirer of contingent liabilities assumed in a business combination.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Provisions are a subset of liabilities. They are distinguished from other liabilities such as trade payables and accruals because they are characterised by uncertainty about the timing or amount of the future expenditure required in settlement. Trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier. Accruals are liabilities to pay for goods or services that have been received but have not been paid or formally agreed with the supplier (they may also relate to amounts due to employees). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Paragraph 2.20 of the *IFRS for SMEs* specifies that an essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way.

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The obligation may be either a legal obligation or a constructive obligation. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement. A constructive obligation is an obligation that derives from an entity's actions and is explained further in 21.6 below.

In some jurisdictions, it has been a practice, under local GAAP, to recognise a liability 'general reserves' for unspecified potential or future losses based on a notion of conservatism or prudence. These are sometimes referred to as provisions. These reserves do not meet the definition of a provision or a liability under the *IFRS for SMEs*. Therefore, recognition as liabilities of such 'general reserves' is prohibited.

Similarly, obligations that arise from future actions of the entity, no matter how likely, are not present obligations and, therefore, do not meet the definition of a provision or a liability. For example, it is inappropriate to recognise a provision for expected future losses, because the entity has no present obligation to incur those losses (eg the entity could cease the operations that will generate the future losses). It is important to bear in mind, however, that the expectation of losses may be an indicator that some of the entity's assets are impaired. Recognition of impairment losses is covered by Section 27 *Impairment of Assets*. Also, if an entity has entered into an onerous contract (see paragraph 21A.2 in the Appendix to Section 21), under which the entity has an unavoidable obligation to incur a loss, then a provision for that loss is appropriate because it arises from a past event—entering into a binding contract—and not from avoidable future loss-making activities.

### Examples – provisions

**Ex 1 Waste from an entity's production process contaminated the groundwater at the entity's plant. In a lawsuit brought against the entity, members of the local community seek compensation for damages to their health as a result of the contamination. The entity acknowledges its wrongdoing and the court is deciding on the extent of the compensation to be awarded to the members of the local community. It is uncertain when the ruling will take place but the entity's lawyers expect it will take place in about two years and they estimate that the compensation awarded by the court will be in the range CU1 million–CU30 million<sup>(1)</sup>.**

The entity has a liability of uncertain timing or amount (ie a provision). At the end of the reporting period the entity has a legal obligation to compensate members of the local community for the damages caused. Because the court is deciding on the extent of compensation to be paid, the amount of future compensation is uncertain. Furthermore, the uncertain timescale for the legal process brings uncertainty to the timing of the payment for damages.

**Ex 2 Waste from an entity's production process contaminated the groundwater at the entity's plant. In this example there is no court case. However, the entity is required by law to restore the contaminated environment.**

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<sup>(1)</sup> In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

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**The entity estimates that such restoration will cost between CU1 million and CU15 million. The entity is unsure of the date by which it will be required to complete the restoration.**

The entity has a liability of uncertain timing or amount (ie a provision). At the end of the reporting period it is obliged by law to restore the damage caused to the environment. There is uncertainty about the timing and amount of the cash flows to restore the environment.

**Ex 3 A manufacturer gives warranties to the purchasers of its goods. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale to the purchasers.**

**On 31 January 20X1 a manufacturing defect was detected in the goods manufactured by the entity between 1 December 20X0 and 31 January 20X1.**

**At 31 December 20X0 (the entity's reporting date) the entity held about one week's sales in inventories.**

**The entity's financial statements for the year ended 31 December 20X0 have not yet been finalised.**

There are three separate categories that require separate consideration.

*Category 1: Defective goods sold on or before 31 December 20X0*

The obligating event is the sale of the product with a warranty. At 31 December 20X0 the entity has a legal obligation to make good the defective goods sold to its customers. The obligation is of uncertain timing or amount (ie a provision).

*Category 2: Defective goods held on 31 December 20X0*

At 31 December 20X0 the entity did not have a present obligation to make good the unsold defective goods that it held in inventories. Accordingly, at 31 December 20X0 the entity must not recognise a provision in respect of the defective inventories. However, the entity must test the inventories for impairment in accordance with Section 27 *Impairment of Assets*.

With respect to this category, the detection of the manufacturing defect in January 20X1 is an adjusting event after the end of the reporting period (see Section 32 *Events after the End of the Reporting Period*). It provides evidence of a manufacturing defect in inventories held at 31 December 20X0.

*Category 3: Defective goods manufactured in 20X1*

At 31 December 20X0 the entity did not have a present obligation to make good any defective goods that it might manufacture in the future. Accordingly, at 31 December 20X0 the entity must not recognise a provision in respect of the defective goods manufactured in 20X1.

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With respect to this category, the detection of the manufacturing defect in January 20X1 is a non-adjusting event after the end of the reporting period (see Section 32 *Events after the End of the Reporting Period*).

### Examples – not provisions—no obligating event

- Ex 4** An entity that operates ten petrol stations and owns the land and buildings for those stations chooses not to purchase fire insurance on those buildings but, rather, to ‘self insure’ in case of fire loss. The entity can estimate reliably the statistical probability of the occurrence and amount of expected fire loss (loss of about CU100,000 once every ten years). The entity wants to recognise a provision of CU10,000 and related expense each year for the next ten years to reflect its expected loss. The entity argues that the loss is highly probable, the amount can be measured reliably, and if it had purchased insurance it would recognise an expense in each reporting period.

The fact that the entity has retained the risk of fire does not create an obligation that is recognised as a provision. An entity that purchases insurance has paid to transfer its risk to a third party, and that payment is properly recognised as an asset (prepayment for services) on the date it is made and then recognised as an expense in profit or loss over the period in which the insurance coverage is consumed, whether or not there is a fire loss.

A fire at one of the stations would be an event that triggers an impairment test on the fire damaged asset. The impairment test might result in the recognition of an impairment loss in profit or loss.

- Ex 5** A ski resort operator operates in a cyclical business, with ‘good years’ and ‘bad years’ depending primarily on the weather. The entity believes that, because of the earnings volatility, it is prudent to defer recognition of a portion of the profit in a ‘good year’ to the inevitable ‘bad year’ by recognising a provision in ‘good years’ and reversing the provision in ‘bad years’. The owners of the entity are in full agreement with recognising a provision in the good year. Also, the local income tax law allows deferral of a portion of the profit in a ‘good year’ to help ensure that ski resort operators have cash to continue operating in ‘bad years’. The amount of the entity’s accrual under the *IFRS for SMEs* is based on the tax law.

At the end of a ‘good year’ the entity does not have an obligation to pay anyone anything in expectation of a ‘bad year’. It is not appropriate to recognise a provision under the *IFRS for SMEs* because there is no liability.

Note: An accrual that is allowed for local income tax purposes is not necessarily the same as an expense or liability to be recognised for financial reporting purposes.

- Ex 6** An entity operates an open-cast mine in a jurisdiction where environmental rehabilitation laws state that all mine shafts deeper than 10 metres must be entirely filled in by 31 December 2X20 or the mining company that dug the holes for the shafts will be required to pay a substantial fine.

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The geologists' reports indicate that the entity will be able to extract significant quantities of ore for at least 20 years. The ore is located 15 metres below the surface.

**At 31 December 20X0 the entity has not started mining.**

At 31 December 20X0 the entity does not have a present obligation. It can avoid both the cost of filling the mine and the fine by abandoning the mining operation before it has dug shafts 10 metres deep.

**At 31 December 20X1 the entity has sunk a shaft 5 metres deep. It is highly likely that the entity will mine beyond 10 metres in the future and therefore will be obliged to fill in each shaft.**

At 31 December 20X1 the entity does not have a present obligation because the shaft is less than 10 metres deep. It can avoid both the cost of filling the mine and the fine by abandoning the mining operation before it has dug shafts 10 metres deep.

**At 31 December 20X2 the entity has sunk a shaft 12 metres deep.**

At 31 December 20X2 a present obligation exists because the entity is required by law to fill in the shaft that exists deeper than 10 metres. Furthermore, the entity has no realistic alternative to filling in the shaft (or paying the fine).

21.2 The requirements in this section do not apply to executory contracts unless they are **onerous contracts**. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

*[Refer: Appendix to Section 21, example 2]*

21.3 The word 'provision' is sometimes used in the context of such items as depreciation, impairment of assets, and uncollectible receivables. Those are adjustments of the **carrying amounts** of assets, rather than recognition of liabilities, and therefore are not covered by this section.

### Initial recognition

21.4 An entity shall recognise a provision only when:

- (a) the entity has an obligation at the **reporting date** as a result of a past event; *[Refer: paragraph 21.5]*
- (b) it is **probable** (ie more likely than not) that the entity will be required to transfer economic benefits in settlement; *[Refer: Appendix to Section 21, particularly example 9]* and
- (c) the amount of the obligation can be estimated reliably.

*[Refer: Appendix to Section 21, examples 2–5, 7 and 9]*

*[For examples that do not satisfy the recognition criteria, refer to Appendix to Section 21, examples 1, 6 and 8]*

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## Notes

### *Reliable estimate of the obligation*

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the statement of financial position.

In the extremely rare case when no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 21.12).

## Examples – initial recognition of provision

- Ex 7** 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 the basis of experience, it is probable that there will be some claims under the warranties.

The best estimate of the amount required to settle the obligation (see paragraph 21.7) must be recognised as a provision when the entity provides the warranties. That amount is also included in profit or loss for the period in which the entity gave the warranties to its customer.

Note: Example 4 explained that a provision is not recognised for self-insured losses that have not yet occurred, no matter how reliably measurable the amount may be. The reason is that until the fire or another 'self-insured' event happens, there is no past event to make the entity obligated for any outflow of resources. Warranties are different. There is a past event that obligates the entity to make repairs or replacements—namely the sale of products with a warranty.

- Ex 8** In a lawsuit brought against an entity, a group of people are collectively seeking compensation for damages to their health as a result of contamination to the nearby land believed to be caused by waste from that entity's production process. It is doubtful whether the entity is the source of the contamination because many entities operate in the same area producing similar waste and the source of the leak is unclear. The entity denies any wrongdoing since it has taken precautions to avoid such leaks and so it is vigorously defending the case. However, the entity cannot be certain that it has not caused the leak and the true offender will become known only after extensive testing. The entity's lawyers expect a court ruling in about two years. If the entity loses the case, compensation is likely to be in the range CU1 million–CU30 million.

Based on the facts above it appears uncertain whether the entity has a present obligation—this is the matter being determined by the court. A past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is probable that a present obligation exists at the reporting date.

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If, taking account of all of the available evidence, it is probable that the entity will lose the court case then the entity is deemed to have a present obligation and hence a liability of uncertain timing or amount (a provision).

If, taking account of all of the available evidence, it is probable that the entity will successfully defend the court case then the entity has a possible obligation and hence a contingent liability (see paragraph 21.12).

21.5 The entity shall recognise the provision as a liability in the statement of financial position and shall recognise the amount of the provision as an expense, unless another section of this IFRS requires the cost to be recognised as part of the cost of an asset such as inventories or property, plant and equipment.

### Examples – initial recognition of provision as part of the cost of an asset

**Ex 9 An entity constructed an item of equipment for use in its manufacturing operations. Because of constructing the asset, the entity is required by law at the end of the equipment's useful life to dismantle the equipment, to prepare it for recycling and to deliver it to the local government's recycling facility.**

The best estimate of the amount required to settle the obligation (see paragraph 21.7(b)) must be recognised as a provision (a liability) when the plant is constructed.

That amount is also included in the cost of the plant (an asset) in accordance with paragraph 17.10(c) of the *IFRS for SMEs* rather than included in profit or loss in the period of construction. The effect of this is to increase the cost of the asset (ie the item of equipment) by the same amount as is recognised as a provision. The additional amount added to the cost of the asset will be recognised as depreciation over the useful life of the asset (see Section 17 *Property, Plant and Equipment*). Depreciation of manufacturing equipment will generally be added to the cost of the inventories produced. The cost of the inventories produced will be recognised in profit or loss when the related revenue is recognised. The obligation to dismantle and recycle arises from the construction of the equipment.

**Ex 10 Effluent discharged from an entity's manufacturing process contaminates the land on which the entity operates. At the end of the plant's useful life the entity is required to restore the land.**

The best estimate of the amount required to settle the obligation (see paragraph 21.7(b)) must be recognised as a provision (a liability) when the entity contaminates the land—the obligation to restore the environment arises from the manufacturing process.

21.6 The condition in paragraph 21.4(a) (obligation at the reporting date as a result of a past event) means that the entity has no realistic alternative to settling the obligation. This can happen when the entity has a legal obligation that can be enforced by law or when the entity has a **constructive obligation** because the past event (which may be an action of the entity) has created valid expectations in other parties that the entity will discharge the obligation. Obligations that will arise from the entity's future actions (ie the future conduct of its business) do not satisfy the condition in paragraph 21.4(a), no matter how likely they are to occur and even if they are contractual. To illustrate, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to

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operate in a particular way in the future (for example, by fitting smoke filters in a particular type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation or selling the factory, it has no present obligation for that future expenditure and no provision is recognised.

*[For examples of constructive obligations refer to Appendix to Section 21, examples 3, 5 and 7]*

### Notes

Paragraph 2.20 of the *IFRS for SMEs* specifies that an essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way.

The obligation may be either a legal obligation or a constructive obligation. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement. A constructive obligation is an obligation that derives from an entity's actions when:

- (a) 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 particular responsibilities; and
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

### Examples – obligating event

**Ex 11 An entity has made a written pledge to contribute a substantial sum of money toward the construction of a new performing arts centre in its community. Executives of the entity appeared in a press conference to announce the pledge. With the entity's consent, the charitable organisation that is building the arts centre has cited the entity's pledge in its materials soliciting additional pledges for construction. Under local law, pledges to charitable organisations are not legally enforceable.**

Although the pledge may not be legally enforceable, by participating in the press conference and by allowing its name to be used in the solicitation, the entity has indicated that it has accepted an obligation to honour its pledge and has created a valid expectation on the part of the arts centre that it will do so (ie its actions have given rise to a constructive obligation). The entity should recognise a provision.

**Ex 12 Waste from an entity's production process contaminated the groundwater at the entity's plant. The entity is not required by law to restore the contaminated environment and there is no court case. However, before the end of the current reporting period the entity made a public announcement that it would restore the contaminated environment within the next 12 months.**

The entity has indicated to the public that it will accept responsibility to restore the contaminated environment and has as a result created a valid expectation on the part of the public that it will discharge this responsibility. Therefore at the end of the reporting period the entity has a constructive obligation to restore the damage caused to the



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environment. There is uncertainty about the amount of the cash flows to restore the environment. The entity has liability of uncertain timing or amount (ie a provision).

### Initial measurement

21.7 An entity shall measure a provision at the best estimate of the amount required to settle the obligation at the reporting date. The best estimate is the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

(a) When the provision involves a large population of items, the estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. 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.

*[Refer: Appendix to Section 21, example 4]*

(b) When the provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation. However, even in such a case, the entity considers other possible outcomes. When other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

### Notes

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the statement of financial position. Judgement may need to be exercised in measuring provisions. In nearly all cases the estimates can be made with sufficiently reliability to recognise a provision.

The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. It might be impossible or prohibitively expensive to settle or transfer an obligation at the end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

An entity applies judgement in measuring the estimated settlement amount. Such judgement should reflect experience from similar transactions and also consider any evidence of conditions that existed at the reporting date provided by events after the reporting date but before the financial statements are authorised for issue.

Section 32 *Events after the End of the Reporting Period* (paragraph 32.5(a)) includes an example of an event after the reporting date—settlement of a court case—that could affect the recognition and measurement of a provision.

Future events that may affect the amount required to settle an obligation (eg a future change in technology that would reduce the costs of restoring a site) are reflected in the

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amount of a provision only when there is sufficient objective evidence that those future events will occur. Therefore an entity does not, for example, anticipate the development of a completely new technology.

*[Paragraph 21.7 continued]* When the effect of the time value of money is **material**, the amount of a provision shall be the **present value** of the amount expected to be required to settle the obligation. The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money. The risks specific to the liability should be reflected either in the discount rate or in the estimation of the amounts required to settle the obligation, but not both.

### Notes

In some cases it will be necessary to perform a discounted cash flow calculation to determine the present value of the settlement amount in order to assess whether the time value of money is material. However, in other cases it may be clear that adjusting for the time value of money would not have a material impact on the financial statements. This may be the case, for example, if the time period until settlement is short or the provision is small relative to other amounts in the statement of financial position. It is important to assess materiality in relation to both the statement of financial position and the statement of comprehensive income.

Provisions are measured before tax. The tax consequences of the provision, and the tax consequences of a change in the measurement of a provision after it is initially recognised, are dealt with under Section 29 *Income Tax*.

The risks and uncertainties that inevitably surround many events and circumstances must be taken into account in reaching the best estimate of a provision. When risks specific to the liability are reflected in the estimation of the cash outflows required to settle the obligation, the appropriate discount rate will be a pre-tax risk-free rate such as the yield on a current government bond rate. Alternatively, when the risks specific to the liability are not reflected in the estimation of the amounts required to settle the obligation, they are taken account of by adjusting the discount rate (eg the appropriate discount rate will be a pre-tax risk-free rate such as a current government bond rate less an appropriate adjustment for risk). To take those risks both as an adjustment to the cash flows and as an adjustment to the discount rate would result in double counting them.

The yield on a current fixed rate government bond is frequently different from the coupon rate on that bond. Furthermore, government bonds with different maturity dates frequently yield different rates. The yield on a government bond with a maturity date that approximates the timing of the expected cash flow is usually considered to be indicative of the risk-free rate for that cash flow. It follows that when settlement of a provision is expected to take place over more than one date then different discount rates may apply to the cash flows that are expected to take place at the different dates (see Example 4 Warranties in the Appendix to this section).

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### Examples – initial measurement

- Ex 13** An entity's production process causes contamination to the land on which the entity's plant is built. The entity is required by law to restore the environment at the end of its plant's useful life. The entity envisages costs varying between CU200,000 and CU275,000.

After probability-weighting the various clean-up cost scenarios, the expected cash outflows are estimated to be CU231,250. The entity increases these by 5 per cent, which is the adjustment expected to reflect the uncertainties in the cash flow estimates. It discounts the risk-adjusted cash flows by the appropriate risk-free rate, say 6 per cent per year, to reflect the time value of money. The result is that the provision is measured at CU135,586.

- Ex 14** An entity sells 1,000 units of a product with warranties under which the entity will repair any manufacturing defects that become apparent within the first six months after purchase. If a minor defect is detected in a product, estimated repair costs of CU100 will result. If a major defect is detected in a product, estimated repair costs of CU400 will result. The entity's experience together with its future expectations indicate that 75 per cent of the goods sold have no defects, 20 per cent of the goods sold have minor defects and 5 per cent of the goods sold have major defects.

For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.

In accordance with paragraph 21.7(a), when the provision involves a large population of items, the best estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities.

The expected value of the cost of repairs is

$$(75\% \times 1,000 \text{ units sold} \times \text{nil}) + (20\% \times 1,000 \text{ units} \times \text{CU}100) + (5\% \times 1,000 \text{ units} \times \text{CU}400) = \text{CU}40,000.$$

Therefore a provision of CU40,000 would be appropriate (ignoring the effect of discounting).

- Ex 15** A customer has initiated a lawsuit against an entity associated with personal injury when using one of the entity's products. The entity's lawyers estimate from experience that at the reporting date (31 December 20X1) the entity has a 30 per cent chance of being ordered to pay the customer compensation of CU2 million and a 70 per cent chance of being ordered to pay compensation of CU300,000.

The ruling is expected to take place in two years' time. The risk-free discount rate based on two-year government bonds is 5 per cent. The entity determines that a discount rate of 4 per cent is appropriate to adjust for the risks specific to the liability.

The outcome is expected to be a cash outflow of either CU2 million or CU300,000 in two years' time. The individual most likely outcome is that compensation of CU300,000 will be paid to settle the obligation. However, because the other possible outcome is higher than the most likely outcome, the best estimate to settle the obligation at 31 December 20X1 will be higher than the present value of the most likely outcome of CU300,000.

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In accordance with the principle of determining the amount required to settle the obligation at the reporting date (31 December 20X1) the entity could use an expected value approach to determine the amount. Therefore it would be appropriate to recognise a provision for the present value of the expected value of CU810,000. In which case, the entity would recognise a provision of approximately CU748,891 at 31 December 20X1.

Calculations:

Expected value:  $(30\% \times \text{CU}2,000,000) + (70\% \times \text{CU}300,000) = \text{CU}810,000$ .

Risk-adjusted present value of the expected value:  $\text{CU}810,000 \times (1/1.04) \times (1/1.04) = \text{CU}748,891$ .

**Ex 16 The facts are the same as in example 15. However, in this example, the lawyers estimate that the entity has a 25 per cent chance of being ordered to pay the customer compensation of CU100,000, a 50 per cent chance of being ordered to pay compensation of CU300,000 and a 25 per cent chance of being ordered to pay compensation of CU500,000.**

**For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.**

The outcome of the case is expected to result in an outflow of CU100,000, CU300,000 or CU500,000. Paragraph 21.7(b) states that when the provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation. On the basis of the facts above, the individual most likely outcome is that compensation of CU300,000 will be paid. Because the other possible outcomes are neither mostly higher nor mostly lower than the most likely outcome a provision of CU300,000 is appropriate.

**Ex 17 The facts are the same as in example 15. However, in this example, the lawyers estimate that the entity has a 60 per cent chance of winning the lawsuit and thereby avoiding the payment of compensation. Furthermore, the entity's lawyers estimate that the entity has a 20 per cent chance of being ordered to pay the customer compensation of CU2 million and a 20 per cent chance of being ordered to pay compensation of CU300,000.**

**For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.**

In this case, the entity has a contingent liability (see paragraph 21.12) not a provision. The contingent liability is not recognised in the entity's statement of financial position because it fails to meet one or both of the conditions (b) and (c) in paragraph 21.4. However, the requirements of paragraph 21.7 are relevant to estimating the financial effect of the contingent liability that the entity would disclose in accordance with paragraph 21.15.

**Ex 18 The facts are the same as in example 15. However, in this example, the lawyers estimate that the entity has a 25 per cent chance of winning the lawsuit and thereby avoiding the payment of compensation. Furthermore, the entity's lawyers estimate that the entity has a 35 per cent chance of being ordered to pay the**

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**customer compensation of CU2 million and a 40 per cent chance of being ordered to pay compensation of CU300,000.**

**For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.**

The outcome of the case is expected to result in no compensation being awarded or, if the case is lost, an outflow of CU2 million or CU300,000. The individual most likely outcome is that compensation of CU300,000 will be paid to settle the obligation.

However, because the other possible outcomes are mostly higher than the most likely outcome, the best estimate to settle the obligation at 31 December 20X1 will be higher than the present value of the most likely outcome of CU300,000.

In accordance with the principle of determining the amount required to settle the obligation at the reporting date (31 December 20X1) it would be appropriate to recognise a provision at 31 December 20X1 of approximately CU820,000 (its expected value)<sup>(2)</sup>.

Calculation:

Expected value:  $(CU0 \times 25\%) + (CU2,000,000 \times 35\%) + (CU300,000 \times 40\%) = CU820,000$ .

**21.8** An entity shall exclude gains from the expected disposal of assets from the measurement of a provision.

**21.9** When some or all of the amount required to settle a provision may be reimbursed by another party (eg through an insurance claim), the entity shall recognise the reimbursement as a separate asset only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation. The amount recognised for the reimbursement shall not exceed the amount of the provision. The reimbursement receivable shall be presented in the statement of financial position as an asset and shall not be offset against the provision. In the statement of comprehensive income, the entity may offset any reimbursement from another party against the expense relating to the provision.

### Notes

Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly.

In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability. When it is virtually certain that reimbursement will be received if the entity settles the liability, a separate asset is recognised for the expected reimbursement.

<sup>(2)</sup> The individual most likely outcome is CU300,000. Because other possible outcomes are mostly higher than CU300,000 in expectation the best estimate must be adjusted. To make the adjustment, this entity uses an expected value calculation. Other methods of adjusting that are consistent with the measurement principle—the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time—are also acceptable.

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This is consistent with the accounting treatment required for contingent assets (see paragraph 21.13).

In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they are not included in the provision.

The following is a summary of the requirements for reimbursements:

*Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.*

<p><i>The entity has no obligation for the part of the expenditure to be reimbursed by the other party.</i></p>	<p><i>The obligation for the amount expected to be reimbursed remains with the entity. It is virtually certain that reimbursement will be received if the entity settles the provision.</i></p>	<p><i>The obligation for the amount expected to be reimbursed remains with the entity. The reimbursement is not virtually certain if the entity settles the provision.</i></p>
<p>The entity has no liability for the amount to be reimbursed.</p>	<p>The reimbursement is recognised as a separate asset in the statement of financial position and may be offset against the expense in the statement of comprehensive income. The amount recognised for the expected reimbursement does not exceed the liability (paragraph 21.9).</p>	<p>The expected reimbursement is not recognised as an asset (paragraphs 21.8 and 21.9).</p>
<p>No disclosure is required.</p>	<p>Disclose the amount of any expected reimbursement and also the amount recognised as an asset for that expected reimbursement (paragraph 21.14(d)).</p>	<p>Disclose the amount of any expected reimbursement (paragraph 21.14(d)).</p>

### Examples – reimbursements

**Ex 19** A retailer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the retailer undertakes to make good, by repair or replacement, any defects in the product (other than those caused by the purchaser) that become apparent within three years from the date of sale. On the basis of experience, it is probable that there will be some claims under the warranties.

The retailer receives warranties at the time of purchase of those products from the manufacturer. Under the terms of the contract for purchase the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three and a half years from the date of purchase.

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**It should be noted that the manufacturer has warranted only against manufacturing defects, whereas the retailer's warranty also covers additional defects that arose while the product was in the retailer's possession.**

**On average the retailer holds inventory for six months.**

*Accounting by the retailer*

The retailer must recognise the best estimate of the amount required to settle the warranty obligation (see paragraph 21.7(a)) as a provision at the time of the sale to the purchasers of its product. Whether and at what amount it recognises a related reimbursement asset receivable from the manufacturer depends on the terms of its contract with the manufacturer (see below).

Under the terms of the contract for purchase the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three and a half years from the date of purchase. If such manufacturing defects become apparent while the products are in the retailer's possession and the manufacturer accepts the defective goods returned by the retailer, then the retailer will account for the return of inventory to the manufacturer. No reimbursement asset will be recognised.

For manufacturing defects that become apparent after products are sold to purchasers, the retailer recognises a reimbursement asset only for those defective products when it is virtually certain that the manufacturer will repair/replace the product when the retailer is obligated to repair/replace the product for its purchasers. The amount to be recognised by the retailer for the reimbursement asset relating to goods sold to the purchasers is not necessarily the same amount as the retailer recognises for the warranty liability. For example, the manufacturer may not repair/replace the defective products for the retailer if it considers that the damage to the products was caused while the product was in the retailer's possession.

*Accounting by the manufacturer*

The manufacturer must recognise the best estimate of the amount required to settle its own warranty obligation (see paragraph 21.7(a)) as a provision (a liability) when it sells the goods to the retailer. The manufacturer would not recognise a reimbursement asset.

**Ex 20 A manufacturer sells products to a retailer. The retailer sells those products to purchasers.**

**Any products that are unsold by the retailer after a six-month period can be returned to the manufacturer, except for those products that have been damaged while in the possession of the retailer. The terms of the sale or return agreement are such that the manufacturer recognises revenue only when the retailer sells the products to purchasers.**

**The manufacturer gives warranties directly to the purchasers. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale to the purchasers. The purchasers are informed that the warranty contract is with the manufacturer when purchasing the products. Purchasers must send any defective products direct to the manufacturer for repair or replacement. On the**

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**basis of experience, it is probable that there will be some claims under the warranties.**

The retailer has no rights and no obligations relating to the warranties provided to the purchasers by the manufacturer. The retailer is not party to the warranties and must not recognise a warranty provision in its financial statements. If products are damaged while in the possession of the retailer, then an expense would be recognised by the retailer for those products.

The manufacturer must recognise the best estimate of the amount required to settle the warranty obligation (see paragraph 21.7(a)) as a provision (a liability) on the date when the retailer sells the products to the purchasers. Revenue is also recognised by the manufacturer on this date (see Section 23 *Revenue*), and not on the date the products are sold to the retailer.

**Ex 21 The facts are the same as in example 20. However, in this example, products that are unsold by the retailer cannot be returned to the manufacturer.**

The retailer has no rights and no obligations relating to the warranties provided to the purchasers by the manufacturer. The retailer is not party to the warranties and must not recognise a warranty provision in its financial statements. If products are damaged while in the possession of the retailer or if products cannot be sold, then an expense would be recognised for those products.

The manufacturer must recognise the best estimate of the amount required to settle the warranty obligation (see paragraph 21.7(a)) as a provision (a liability) when the manufacturer sells the products to the retailer. Revenue is also recognised by the manufacturer on this date (see Section 23 *Revenue*), and not on the date the products are sold to the purchaser by the retailer.

## Subsequent measurement

21.10 An entity shall charge against a provision only those expenditures for which the provision was originally recognised.

### Examples – expenditures charged against a provision

**Ex 22 An entity recognised a CU40,000 provision for a lawsuit at 31 December 20X1. In March 20X2 the case was dismissed without the right to appeal. In April 20X2 the entity undertook an advertising campaign costing CU40,000. The entity made the following entry in its accounting records to recognise the advertising campaign:**

**April 20X2**

<b>Dr</b>	<b>Provision for lawsuit (liability)</b>	<b>CU40,000</b>	
	<b>Cr Cash</b>		<b>CU40,000</b>

***To set off the cost of the advertising campaign against the provision for the lawsuit.***



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The above journal entry is incorrect. The entity must not charge the cost of its advertising campaign against the provision for a lawsuit because it is not an expenditure for which the provision was originally recognised.

The entity should have accounted for the events as follows:

March 20X2

Dr	Provision for lawsuit (liability)	CU40,000	
	Cr Profit or loss		CU40,000

*To recognise the change in an accounting estimate made in a prior period for the expected settlement of a lawsuit that was dismissed by the court in March 20X2.*

April 20X2

Dr	Profit or loss	CU40,000	
	Cr Cash		CU40,000

*To recognise the cost of the advertising campaign.*

Note: In this example the effects of the increase during the period in the discounted amount arising from the passage of time have been ignored.

**Ex 23 At 31 December 20X1 an entity recognised a CU50,000 provision for environmental damage lawsuit (Case A).**

**In September 20X2 the Case A was dismissed without the right to appeal.**

**In December 20X2 an unrelated lawsuit for patent infringement (Case B) was brought against the entity. Later that month, the court ruled against the entity in Case B. In accordance with the verdict the entity paid the plaintiff damages of CU40,000.**

**In 20X2, the entity made the following entry in its accounting records to recognise these events:**

December 20X2

Dr	Provision for lawsuit (liability)	CU50,000	
	Cr Profit or loss		CU10,000
	Cr Cash		CU40,000

***To set off the reversal of the provision for Case A against the liability for Case B.***

The above journal entry is incorrect. The entity must not charge the cost of the damages paid in Case B against the provision for a recognised for Case A.

The entity should have accounted for the events as follows:

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September 20X2

Dr	Provision for lawsuit (liability)	CU50,000 <sup>(a)</sup>	
	Cr Profit or loss		CU50,000

*To recognise the change in an accounting estimate made in a prior period for the expected settlement of lawsuit Case A that was dismissed by the court in September 20X2.*

<sup>(a)</sup> This amount would be separately disclosed in accordance with paragraph 21.14(a)(ii).

December 20X2

Dr	Profit or loss	CU40,000	
	Cr Cash		CU40,000 <sup>(b)</sup>

*To recognise the settlement of Case B—patent infringement.*

<sup>(b)</sup> This amount would be separately disclosed in accordance with paragraph 21.14(a)(ii).

Note: In this example the effects of the increase during the period in the discounted amount arising from the passage of time have been ignored.

**Ex 24 At 31 December 20X1 an entity recognised a CU400,000 provision for an announced restructuring of its operations.**

**In 20X2 the entity completed that restructuring at a lower than expected cost of CU350,000. The entity decided to utilise CU37,000 of the amount that had been provided for but not used in the restructuring to acquire a new office equipment. The purchase of the office equipment is unrelated to the restructuring.**

**The entity recorded the purchase of the office equipment as follows:**

Dr	Provision for restructuring (liability)	CU37,000	
	Cr Cash		CU37,000

*To recognise the purchase of office equipment.*

The above journal entry is incorrect. The entity must not charge the cost of the office equipment against the provision for the announced restructuring because the office equipment was not part of the restructuring plan. It should have accounted for the cost of the office equipment as follows in the year ended 31 December 20X2:

Dr	Property, plant and equipment	CU37,000	
	Cr Cash		CU37,000

*To recognise the purchase of office equipment.*

After accounting for the effect of the increase during the period in the discounted amount of CU400,000 arising from the passage of time (see 21.11 and the related notes

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below for an explanation), the amount of the provision for the announced restructuring not utilised in that restructuring must be accounted for as a change in accounting estimate (see paragraph 10.16), ie the change in the estimate (which will mean the reversal of the remaining provision) must be recognised as income in the determination of profit or loss for the year ended 31 December 20X2.

21.11 An entity shall review provisions at each reporting date and adjust them to reflect the current best estimate of the amount that would be required to settle the obligation at that reporting date. *[Refer also: Section 32 Events after the End of the Reporting Period]* Any adjustments to the amounts previously recognised shall be recognised in profit or loss unless the provision was originally recognised as part of the cost of an asset (see paragraph 21.5). *[Refer also: Section 10 Accounting Policies, Estimates and Errors particularly paragraphs 10.15–10.17]* When a provision is measured at the present value of the amount expected to be required to settle the obligation, the unwinding of the discount shall be recognised as a finance cost in profit or loss in the period it arises.

### Notes

By their nature provisions are more uncertain than most other items in the statement of financial position. Therefore the use of estimates is an essential part of measuring provisions. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

A change in accounting estimate is defined to be an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

The requirements of paragraph 21.11 for provisions are consistent with the requirements for accounting for changes in accounting estimates (see paragraph 10.16) (ie changes in accounting estimates are applied prospectively). However, if a change needs to be made to the recognised amount of an existing provision, or a new provision needs to be recognised because of a prior period error (see paragraph 10.19) then that error must be corrected retrospectively (ie by restating the comparative amounts (see paragraph 10.21)).

In estimating the amount of provisions an entity adjusts the amounts recognised in its financial statements to reflect events that provide evidence of conditions that existed at the end of the reporting period (ie adjusting events after the end of the reporting period) see Section 32 *Events after the End of the Reporting Period*. Adjusting events reflect new information about the assets and liabilities that were recognised at the end of the reporting period or about the income, expenses, or cash flows that were recognised in the reporting period.

When discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. In other words, the present value of the obligation will increase as the liability becomes closer to settlement.

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### Examples – adjustments to initial measurement of a provision

**Ex 25** An entity recognised a provision for a lawsuit at CU40,000 in its statement of financial position at 31 December 20X1. At 31 December 20X2, the risk-adjusted present value of the best estimate of the amount required to settle the lawsuit is CU90,000. CU3,000 of the increase in the provision is attributable to the unwinding of the discount (ie the increase in the CU40,000 because it is one year closer to settlement) the remainder of the increase is attributed to better information becoming available on which to base the estimates.

At 31 December 20X2 the entity must recognise a provision of CU90,000. The increase of CU50,000 will be recognised as an expense in the determination of the entity's profit or loss for the year ended 31 December 20X2. Of that CU50,000 expense, CU3,000 will be presented as a finance cost and the remaining CU47,000 will be presented as a loss from a lawsuit.

**Ex 26** An entity operates a chemical manufacturing plant for which the licensing agreement requires it to decommission the plant at the end of its useful life. The obligation to decommission arose from the construction of the plant. The plant is accounted for in accordance with Section 17 *Property, Plant and Equipment*.

In its statement of financial position as at 31 December 20X1 (its year-end), the entity reported a provision for decommissioning its chemical manufacturing plant at CU400,000.

At 31 December 20X2 the best estimate of the amount required to settle the decommissioning obligation is CU600,000. CU28,000 of the increase in the provision is attributable to the unwinding of the discount, the remainder of the increase is attributed to better information becoming available on which to base the estimate.

At 31 December 20X2 the entity must recognise a provision of CU600,000. The part of the increase that arises from the unwinding of the discount (ie CU28,000) is a finance cost that must be recognised as an expense in the determination of the entity's profit or loss for the year ended 31 December 20X2. The part of the increase that is attributed to better information becoming available on which to base the estimates (ie CU172,000) is added to the cost of the asset (ie the item of plant). The adjusted depreciable amount of the asset is depreciated over its remaining useful life. Depreciation is recognised as an expense in accordance with Section 17.

Because the adjustment results in an increase in the cost of the asset, the entity should consider whether such an increase is an impairment indicator (ie there may be a chance that carrying amount exceeds the recoverable amount—see Section 27 *Impairment of Assets*).

**Ex 27** An entity provides warranties to purchasers of its products. On 31 December 20X5 an entity assessed its warranty obligation for products sold before 31 December 20X5 at CU100,000. Immediately before the 31 December 20X5 annual financial statements were approved for issue, a customer discovered a latent defect in one of

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**the products purchased from the entity before 31 December 20X5. As a result of the discovery the entity revised its estimate of its warranty obligation at 31 December 20X5 to CU150,000.**

At 31 December 20X5 the obligation for the warranty provision must be measured at CU150,000. This is the determination of an (initial) accounting estimate, not a change in accounting estimate. The latent defect is a condition that existed at end of the reporting period and is therefore taken into account in determining the amount of the obligation at the end of the reporting period even though the information was discovered later (see Section 32 *Events after the End of the Reporting Period* paragraphs 32.1–32.5).

**Ex 28 The facts are the same as in example 27. However, in this example, the latent defect was discovered after the 31 December 20X5 annual financial statements were approved for issue. In July 20X6 the entity paid CU150,000 to transfer the obligation to an independent third party.**

**For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.**

The additional CU50,000 obligation (not provided for at 31 December 20X5) is a change in accounting estimate for the year ended 31 December 20X6. The warranty obligation (provision) was appropriately measured and reported at CU100,000 in the entity's 31 December 20X5 annual financial statements. This estimate needs to be revised in 20X6 because the discovery of the latent defect was made after the 20X5 financial statements were approved for issue. The CU50,000 is recognised as an expense in determining profit or loss for the six-month period ended 30 June 20X6 (see paragraph 10.16).

### Contingent liabilities

21.12 A **contingent liability** is either a possible but uncertain obligation or a present obligation that is not recognised because it fails to meet one or both of the conditions (b) and (c) in paragraph 21.4. An entity shall not recognise a contingent liability as a liability, except for provisions for contingent liabilities of an acquiree in a business combination (see paragraphs 19.20 and 19.21). Disclosure of a contingent liability is required by paragraph 21.15 unless the possibility of an outflow of resources is remote. When an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

### Notes

There are two types of contingent liabilities:

- (a) present obligations that arise from past events and that are not recognised as liabilities because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable

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estimate of the amount of the obligation cannot be made

- (b) 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.

Except for those present obligations of an acquiree that are recognised as contingent liabilities in a business combination, a contingent liability must not be recognised. Possible obligations (see (b) above) are not liabilities and those obligations that are contingent liabilities (see (a) above) must not be recognised because they fail the criteria for recognising a liability.

An obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties. The entity recognises a provision for the part of the obligation that it will have to settle using its own resources, provided a reliable estimate can be made.

*Relationship between provisions and contingent liabilities*

The relationship between provisions and contingent liabilities is summarised as follows: When, 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 and ...

<p>... there is a present obligation that probably requires an outflow of resources. A provision is recognised (paragraph 21.4). Disclosures are required for the provision (paragraph 21.14).</p>	<p>... there is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources. No provision is recognised (paragraph 21.12). Disclosures are required for the contingent liability (paragraph 21.15).</p>	<p>... there is a possible obligation or a present obligation for which the likelihood of an outflow of resources is remote. No provision is recognised (paragraph 21.12). No disclosure is required (paragraph 21.15).</p>
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A contingent liability also arises in the extremely rare case when there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability (paragraph 21.15).

**Example – contingent liabilities**

**Ex 29** In a lawsuit brought against an entity, a group of people are collectively seeking compensation for damages to their health as a result of contamination to the nearby land believed to be caused by waste from that entity’s production process. It is doubtful whether the entity is the source of the contamination because many entities operate in the same area producing similar waste and it is unclear which entity is the source of the leak. The entity denies any wrongdoing because it has

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taken precautions to avoid such leaks and so it is vigorously defending the case. However, the entity cannot be certain that it has not caused the leak and the true offender will become known only after extensive testing. The entity’s lawyers expect a court ruling in about two years. If the entity loses the case, compensation is likely to be in the range of CU1 million to CU30 million.

On the basis of the facts above it may be uncertain whether the entity has a present obligation—this is the matter being determined by the court.

If taking account of all of the available evidence, it is probable that the entity will successfully defend the court case then the entity has a possible obligation and hence a contingent liability.

If taking account of all of the available evidence, it is probable that the entity will lose the court case then the entity is deemed to have a present obligation, and hence a liability of uncertain timing or amount—a provision.

## Contingent assets

21.13 An entity shall not recognise a **contingent asset** as an asset. Disclosure of a contingent asset is required by paragraph 21.16 when an inflow of economic benefits is probable. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.

### Notes

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. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. However, as set out in the table below, when the realisation of income is virtually certain the related asset is not a contingent asset and hence shall be recognised. The relationship between assets and contingent assets is summarised as follows:

When, as a result of past events, there is a possible asset 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 and...

<i>...the inflow of economic benefits is virtually certain.</i>	<i>...the inflow of economic benefits is probable, but not virtually certain.</i>	<i>...the inflow is not probable.</i>
The asset is recognised, it is not contingent (see paragraph 21.13).	No asset is recognised (see paragraph 21.13). Disclosures are required (see paragraph 21.16).	No asset is recognised (see paragraph 21.13). No disclosure is required (see paragraph 21.16).

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## Examples – contingent assets

**Ex 30** An entity is taking legal action against its competitor for patent infringement relating to a patent that had been granted to the entity on one of its products. The outcome of the case is uncertain. However, it is probable that the court will order the competitor to pay damages to the entity.

The entity must disclose the contingent asset as set out in paragraph 21.16 because an inflow of economic benefits is probable, but not virtually certain.

**Ex 31** The facts are the same as in example 30. However, in this example, it is virtually certain that the court will order the competitor to pay damages to the entity.

The entity must recognise an asset. It is not a contingent asset because the virtual certainty of receiving benefits removes the contingency.

**Ex 32** The facts are the same as in example 30. However, in this example, it is probable that the court will rule in favour of the competitor (ie it is probable that the entity's case will not be successful).

An asset must not be recognised. Because an inflow of economic benefits is not probable the contingent asset also is not disclosed.

## Disclosures

### Disclosures about provisions

*[Refer also: paragraphs 4.2(p) and 4.11(e)]*

21.14 For each class of provision, an entity shall disclose all of the following:

- (a) a reconciliation showing
  - (i) the carrying amount at the beginning and end of the period;
  - (ii) additions during the period, including adjustments that result from changes in measuring the discounted amount;
  - (iii) amounts charged against the provision during the period; and
  - (iv) unused amounts reversed during the period.
- (b) a brief description of the nature of the obligation and the expected amount and timing of any resulting payments.
- (c) an indication of the uncertainties about the amount or timing of those outflows.
- (d) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Comparative information for prior periods is not required.



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## Example – disclosures about provisions

Ex 33 An entity could present disclosures about its provisions as follows:

### Note 2 Accounting policies

#### Provisions

A provision is recognised when the entity has a present obligation as a result of a past event, it is probable that the entity will be required to settle the obligation, and the amount of the obligation can be estimated reliably. A provision is measured at the best estimate of the amount required to settle the obligation at the reporting date. The best estimate is the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. It is determined taking into account any risks and uncertainties relating to the obligation and discounted to reflect the time value of money by using a pre-tax risk-free discount rate based on government bonds with the same term as the expected cash outflows.

### Note 22 Provisions

	<i>Warranties</i>	<i>Decommissioning</i>	<i>Total</i>
	<i>CU</i>	<i>CU</i>	<i>CU</i>
Carrying amount at 31 December 20X1	20,000	40,000	60,000
Unwinding of the discount	1,000	3,000	4,000
Additions	90,000	–	90,000
Settled in the period	(40,000)	–	(40,000)
Unused amounts reversed	(10,000)	(8,000)	(18,000)
Carrying amount at 31 December 20X2	<b>61,000</b>	<b>35,000</b>	<b>96,000</b>
Analysed as follows:			
Current	40,000	–	40,000
Non-current	21,000	35,000	56,000
	<b>61,000</b>	<b>35,000</b>	<b>96,000</b>

#### Product warranties

A provision is recognised for expected claims on products sold with a two-year warranty. The entity undertakes to make good, by repair or replacement, manufacturing defects that become apparent within two years from the date of sale. The carrying amount of the warranty provision is estimated at the end of the reporting period using probability-weighted expected values based on experience taking into account any circumstances that have affected product quality.

#### Decommissioning

A provision is recognised for the legal obligation to decommission the chemical manufacturing plant at [place X] in [jurisdiction Y]. The carrying amount of the decommissioning provision is estimated at the end of the reporting period using published industry benchmark information for similar projects in [jurisdiction Y]. However, adjustments are made to take into account the effect of new technology, the

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development of which is nearing completion because there is sufficient objective evidence that such technology will be ready for commercial use by the time that the entity's plant needs to be decommissioned. If this technology were not taken into account the amount of the provision would be 10 per cent higher. Furthermore, the government of jurisdiction Y is currently reviewing its environmental legislation. Current legislation requires only that the plant be decommissioned. As part of the environmental review, discussion is taking place regarding whether the law should be changed to require entities also to decontaminate any affected land surrounding the plant. Because it is uncertain whether the law will be changed, the effect of this possible change is not included in the carrying amount of the provision.

### Disclosures about contingent liabilities

*[Refer also: paragraph 8.4(d)]*

- 21.15 Unless the possibility of any outflow of resources in settlement is remote, an entity shall disclose, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, when practicable:
- (a) an estimate of its financial effect, measured in accordance with paragraphs 21.7–21.11;
  - (b) an indication of the uncertainties relating to the amount or timing of any outflow; and
  - (c) the possibility of any reimbursement.

If it is **impracticable** to make one or more of these disclosures, that fact shall be stated.

*[Refer: Illustrative Financial Statements, note 24]*

### Notes

If disclosure of the estimated financial effect of a contingent liability is required, it is measured in the same way as a provision—the best estimate of the amount that would be required to settle it at the reporting date (see paragraphs 21.7 to 21.11).

It is impracticable to apply a requirement if it cannot be applied after making every reasonable effort to do so. Impracticable is a high hurdle.

### Example – disclosures about contingent liabilities

Ex 34 An entity could present disclosures about its contingent liabilities as follows:

#### Note 30 Contingent liabilities

A customer has instigated legal proceedings against the entity, alleging personal injury resulting from use of the entity's products. The customer has claimed compensation of CU2 million. On the basis of legal advice, management has concluded that the claim has no merit and fully expects that the court to rule in favour of the entity, with no compensation being awarded to the customer. Management has been advised that, if the courts unexpectedly ruled in favour of the customer, the compensation awarded would probably be no higher than CU300,000.

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## Disclosures about contingent assets

[Refer also: paragraph 8.4(d)]

21.16 If an inflow of economic benefits is probable (more likely than not) but not virtually certain, an entity shall disclose a description of the nature of the contingent assets at the end of the **reporting period**, and, when practicable without undue cost or effort, an estimate of their financial effect, measured using the principles set out in paragraphs 21.7–21.11. If it is impracticable to make this disclosure, that fact shall be stated.

### Notes

It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.

### Example – disclosures about contingent assets

Ex 35 An entity could present disclosures about its contingent assets as follows:

#### Note 31 Contingent assets

In 20X2 entity A instigated legal proceedings against entity B for damages to its aircraft caused by defective aviation fuel produced by entity B.

Entity A's lawyers believe that it is probable that damages of CU60,000 will be awarded by the court.

An asset is not recognised in the financial statements for this possible asset, the existence of which is dependent upon the outcome of the legal proceedings.

## Prejudicial disclosures

21.17 In extremely rare cases, disclosure of some or all of the information required by paragraphs 21.14–21.16 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.

### Notes

In extremely rare cases, described in paragraph 21.17, an entity is permitted to make the specified alternative disclosures (which are set out in paragraph 21.17). However, no relief is provided from the recognition and measurement requirements for provisions (ie in the case of a provision, the entity must recognise the provision and measure it at the best estimate of the amount required to settle the obligation at the reporting date).

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## Appendix to Section 21

### Guidance on recognising and measuring provisions

*This Appendix accompanies, but is not part of, Section 21. It provides guidance for applying the requirements of Section 21 in recognising and measuring provisions.*

All of the entities in the examples in this Appendix have 31 December as their reporting date. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets; this aspect is not dealt with in the examples. References to 'best estimate' are to the present value amount, when the effect of the time value of money is material.

#### Notes

In some examples below the circumstances described are likely to be an indication of impairment of the assets, for example an expectation of future operating losses is an indication that some assets of the operation may be impaired. This aspect is not dealt with in the examples below (refer to Section 27 *Impairment of Assets*).

#### Example 1 Future operating losses

*[Refer also: paragraph 8.4(d)]*

21A.1 An entity determines that it is probable that a segment of its operations will incur future operating losses for several years.

Present obligation as a result of a past obligating event—There is no past event that obliges the entity to pay out resources.

Conclusion—The entity does not recognise a provision for future operating losses. Expected future losses do not meet the definition of a liability. The expectation of future operating losses may be an indicator that one or more assets are impaired—see Section 27 *Impairment of Assets*.

#### Notes

Future operating losses relate to an activity that will continue and are presumed to be avoidable, for example by closure of the segment or operations (ie there is no obligating event—no past event giving rise to a present obligation). Hence no present obligation exists.

#### Example 2 Onerous contracts

*[Refer also: paragraph 8.4(d)]*

21A.2 An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

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The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. For example, an entity may be contractually required under an operating lease to make payments to lease an asset for which it no longer has any use.

Present obligation as a result of a past obligating event—The entity is contractually required to pay out resources for which it will not receive commensurate benefits.

Conclusion—If an entity has a contract that is onerous, the entity recognises and measures the present obligation under the contract as a provision.

### Notes

A provision should be made for any unavoidable net loss from the contract. This should reflect the least net cost of exiting from the contract, either:

- the cost of fulfilling the contract, or
- any penalties arising from failure to fulfil the contract.

In the case of a lease of an asset that is no longer used (see Example 2 above) the provision represents the best estimate of the expenditure required to settle the obligation at the reporting date, which, in this case, might be the amount the landlord would accept to terminate the lease (ie amount that the entity would rationally pay to settle the obligation at the end of the reporting period).

Long-term contracts for the supply of goods when costs have risen or market prices have declined are onerous, and a provision is recognised, if and to the extent that future supplies will be made at a loss. No provision is recognised under a contract for the supply of goods that is profitable, but at a reduced margin compared to other contracts.

### Example 3 Restructurings

*[Refer also: paragraph 8.4(d)]*

21A.3 A restructuring is a programme that is planned and controlled by management and materially changes either the scope of a business undertaken by an entity or the manner in which that business is conducted.

### Notes

The following are examples of events that may be a restructuring as described:

- (a) sale or termination of a line of business;
- (b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
- (c) changes in management structure, for example, eliminating a layer of management; and
- (d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

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*[Paragraph 21A.3 Example 3 Restructurings continued]* Present obligation as a result of a past obligating event—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.

Conclusion—An entity recognises a provision for restructuring costs only when it has a legal or constructive obligation at the reporting date to carry out the restructuring.

### Notes

What this means is that it requires more than management's intentions to accrue a provision for a restructuring. Intentions can change, and they are not past events that obligate the entity. The obligation arises (and a provision must be recognised) when those intentions become unavoidable commitments to pay out resources (eg via a public announcement 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).

### Example 4 Warranties

*[Refer: paragraphs 21.4 and 21.7(a)]*

21A.4 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 the basis of experience, it is probable (ie more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event—The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement—Probable for the warranties as a whole.

Conclusion—The entity recognises a provision for the best estimate of the costs of making good under the warranty products sold before the reporting date.

Illustration of calculations:

In 20X0, goods are sold for CU1,000,000. Experience indicates that 90 per cent of

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products sold require no warranty repairs; 6 per cent of products sold require minor repairs costing 30 per cent of the sale price; and 4 per cent of products sold require major repairs or replacement costing 70 per cent of sale price. Therefore estimated warranty costs are:

CU1,000,000 × 90% × 0 =	CU0
CU1,000,000 × 6% × 30% =	CU18,000
CU1,000,000 × 4% × 70% =	CU28,000
Total	CU46,000

The expenditures for warranty repairs and replacements for products sold in 20X0 are expected to be made 60 per cent in 20X1, 30 per cent in 20X2, and 10 per cent in 20X3, in each case at the end of the period. Because the estimated cash flows already reflect the probabilities of the cash outflows, and assuming there are no other risks or uncertainties that must be reflected, to determine the present value of those cash flows the entity uses a ‘risk-free’ discount rate based on government bonds with the same term as the expected cash outflows (6 per cent for one-year bonds and 7 per cent for two-year and three-year bonds). Calculation of the present value, at the end of 20X0, of the estimated cash flows related to the warranties for products sold in 20X0 is as follows:

Year		Expected cash payments	Discount rate	Discount factor	Present value
		(CU)			(CU)
1	60% × CU46,000	27,600	6%	0.9434 (at 6% for 1 year)	26,038
2	30% × CU46,000	13,800	7%	0.8734 (at 7% for 2 years)	12,053
3	10% × CU46,000	4,600	7%	0.8163 (at 7% for 3 years)	3,755
Total					41,846

The entity will recognise a warranty obligation of CU41,846 at the end of 20X0 for products sold in 20X0.

### Notes

In the example above 20X1 = year 3. At the end of year 3 the entity would also recognise a warranty obligation for goods sold in the previous 2 years to the extent of the remaining obligation to make good, by repair or replacement, manufacturing defects that become apparent within 3 years from the date of sale.

### Example 5 Refunds policy

[Refer: paragraph 21.4 and 21.6]

21A.5 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—The obligating event is the sale

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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 that a proportion of goods will be returned for refund.

Conclusion—The entity recognises a provision for the best estimate of the amount required to settle the refunds.

### **Example 6 Closure of a division—no implementation before end of reporting period**

21A.6 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.

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

Conclusion—The entity does not recognise a provision.

### **Notes**

If the entity communicates and implements the restructure after the end of the reporting period but before the financial statements are authorised for issue, it shall disclose the fact as a non-adjusting event after the end of the reporting period (see paragraph 32.11(e)).

### **Example 7 Closure of a division—communication and implementation before end of reporting period**

*[Refer: paragraphs 21.4 and 21.6]*

21A.7 On 12 December 20X0 the board of an entity decided to close a division making a particular product. On 20 December 20X0 a detailed plan for closing 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—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—The entity recognises a provision at 31 December 20X0 for the best estimate of the costs that would be incurred to close the division at the reporting date.



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### Example 8 Staff retraining as a result of changes in the income tax system

21A.8 The government introduces changes to the income tax system. As a result of those 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 tax regulations. At the end of the reporting period, no retraining of staff has taken place.

Present obligation as a result of a past obligating event—The tax law change does not impose an obligation on an entity to do any retraining. An obligating event for recognising a provision (the retraining itself) has not taken place.

Conclusion—The entity does not recognise a provision.

### Example 9 A court case

*[Refer: paragraphs 21.4 and 21.12]*

21A.9 A customer has sued Entity X, seeking damages for injury the customer allegedly sustained from using a product sold by Entity X. Entity X disputes liability on grounds that the customer did not follow directions in using the product. Up to the date the board authorised the financial statements for the year to 31 December 20X1 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 December 20X2, its lawyers advise that, owing to developments in the case, it is now probable that the entity will be found liable.

(a) At 31 December 20X1

Present obligation as a result of a past obligating event—On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion—No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 December 20X2

Present obligation as a result of a past obligating event—On the basis of the evidence available, there is a present obligation. The obligating event is the sale of the product to the customer.

An outflow of resources embodying economic benefits in settlement—Probable.

Conclusion—A provision is recognised at the best estimate of the amount to settle the obligation at 31 December 20X2, and the expense is recognised in profit or loss. It is not a correction of an error in 20X1 because, on the basis of the evidence available when the 20X1 financial statements were approved, a provision should not have been recognised at that time.

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## SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty are useful in assessing the financial position, performance and cash flows of an entity. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties.

### Initial recognition

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In accordance with Section 21 *Provisions and Contingencies* a small or medium-sized entity must determine whether a present obligation that an entity has at the reporting date as a result of a past event gives rise to a provision or a contingent liability. This is important because provisions are recognised in the statement of financial position whereas contingent liabilities (except for contingent liabilities of an acquiree in a business combination) are not. Usually little difficulty is encountered in determining whether a present obligation gives rise to a provision. However, in some cases significant judgement may be necessary in evaluating whether the liability recognition criteria are satisfied.

#### *Existence of a present obligation*

In rare cases, when it is not clear whether there is a present obligation (or a possible obligation), a past event is deemed to give rise to a present obligation (see paragraph 21.4(a)) if, taking account of all available evidence, it is probable that a present obligation exists at the reporting date. In such rare cases, significant judgement may need to be applied in evaluating the available evidence (eg the opinion of experts or additional evidence from events occurring after the reporting period) to determine whether it is probable that a present obligation exists at the reporting date.

Examples of scenarios in which the exercise of significant judgement may be necessary to determine whether a present obligation exists include:

- when, in the absence of a legal obligation, the actions of the entity (eg established pattern of past practice, published policies or a sufficiently specific current statement) might have indicated to other parties that it will accept particular responsibilities and has created valid expectations in other parties that the entity will discharge those responsibilities (ie determining whether a constructive obligation has arisen).
- when a lawsuit is brought against an entity, seeking compensation for damages to third parties' health as a result of environmental contamination alleged to have been caused by waste from that entity's production process. It is unknown whether the entity is the source of the contamination and the true source of the contamination will become known only after extensive testing.

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*More likely than not an outflow of benefits will be required*

The cut-off for the probability recognition criteria (see paragraph 21.4(b))—more likely than not, ie more than a 50 per cent probability—can be particularly problematic in classifying those present obligations that are only marginally more (or less) likely than not. In some cases significant judgement may be required to determine whether a marginal outcome is more likely than not and hence probable.

Examples of scenarios in which the exercise of significant judgement may be necessary to determine whether an outflow of benefits will be required in respect of a present obligation include, for example, when as a result of the entity's negligence a third party has a legal right to claim compensation from the entity and, on the basis of the evidence available, there is approximately an equal chance of the entity winning or losing the lawsuit.

*Ability to measure reliably*

Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and therefore can make an estimate of the obligation that is sufficiently reliable to use in recognising a provision (see paragraph 21.4(c)). In some cases, significant judgement may be required to determine whether the obligation can be measured with sufficiently reliability to recognise a provision.

## **Measurement**

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Provisions are recognised and measured at the best estimate of the amount required to settle the present obligation at the reporting date. The best estimate is the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the statement of financial position. Because of such uncertainties it may require significant judgement to determine the best estimate of the amount required to settle the present obligation at the reporting date.

### **Example – Lawsuit**

The effects of discounting have been ignored in this simplified example.

An entity is defending a one-off lawsuit. On the basis of legal advice, management estimates that the entity has a 60 per cent chance of being found liable and required to pay CU100 million and a 40 per cent chance of being found not liable, with no payment being required. There is no indication that the counterparty would be willing to settle out of court.

CU100 million is the most likely outcome. Because other possible outcomes are lower (eg nil) the provision is measured at an amount lower than CU100 million (see paragraph 21.7(b)).

One way of making the adjustment would be to measure the provision using probability-weighted expected cash flows (ie CU60 million = 60% × 100 million + 40% × nil).

Management cannot be certain that it has correctly predicted the outcomes and their probabilities and therefore makes an adjustment for risk. Judgement is applied and the risk adjustment is estimated to be CU10 million. The maximum amount that a third party in the

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reporting entity's position would rationally pay to either the counterparty (to settle the obligation) or another third party (to transfer the obligation) is CU70 million. An entity is likely to have other motives if it would consider paying more.

There may be third parties that are willing to assume the obligation, and evidence that the amount the third parties would demand would be less than CU70 million. Perhaps this would be the case if third parties specialised in contesting this type of claim and are more likely to achieve a favourable outcome,

If this were the case, the amount that the entity would rationally pay to settle the obligation might be less than CU70 million. Further judgements may be necessary if the counterparty might be prepared to settle out of court.

### Example – Warranties

Experience of the extent of defects in products subject to warranty is likely to be useful in estimating the amount required to settle the present obligation at the reporting date. Such experience is likely to be more persuasive when the product has been produced using the same materials and processes over many years.

Measuring provisions for new products or longstanding products manufactured with new materials or processes has increased uncertainties. However, even in such cases the entity might have experience of defect levels when other new products or processes were introduced. That experience may be useful when estimating the defect levels in the new products and new production processes implemented in the current reporting period.

In accordance with Section 32 *Events after the End of the Reporting Period* information about a warranty obligation that existed at the reporting date is collected until the financial statements are authorised for issue.

### Disclosure

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Although not recognised in the statement of financial position, in specific circumstances estimates of the financial effect of contingent liabilities are disclosed in the notes. In some cases significant judgements may be required to identify the financial effects to be disclosed attributable to the uncertainties inherent in contingent liabilities.

# Module 21 – Provisions and Contingencies

## COMPARISON WITH FULL IFRSs

Full IFRSs (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) and the *IFRS for SMEs* (see Section 21 *Provisions and Contingencies*) as issued at 9 July 2009 share the same principles for accounting and reporting provisions and for disclosing contingent liabilities and contingent assets. However, the *IFRS for SMEs* is drafted in simple language and includes significantly less guidance on how to apply the principles.

# Module 21 – Provisions and Contingencies

## TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting provisions, contingent liabilities and contingent assets in accordance with the *IFRS for SMEs* by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume all amounts are material.

**Mark the box next to the most correct statement.**

### Question 1

A provision is:

- (a) a liability of uncertain timing or amount.
- (b) a possible obligation as a result of past events that is of uncertain timing or amount.
- (c) an adjustment to the carrying amount of assets (eg attributable to impairment or uncollectability).

### Question 2

An entity recognises a provision only when:

- (a) the entity has a present obligation as a result of a past event.
- (b) it is probable (ie more likely than not) that the entity will be required to transfer economic benefits in settlement.
- (c) the amount of the obligation can be estimated reliably.
- (d) all of the above apply.
- (e) only (a) and (b) above apply.

### Question 3

An entity measures a provision at the best estimate of the amount required to settle the obligation at the reporting date. When the provision involves a large population of items, the estimate of the amount:

- (a) reflects the weighting of all possible outcomes by their associated probabilities.
- (b) is determined as the individual most likely outcome.
- (c) may be the individual most likely outcome. However, the entity should also consider the other possible outcomes.

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### Question 4

An entity measures a provision at the best estimate of the amount required to settle the obligation at the reporting date. When the provision arises from a *single obligation*, the estimate of the amount:

- (a) reflects the weighting of all possible outcomes by their associated probabilities.
- (b) is determined as the individual most likely outcome.
- (c) the individual most likely outcome adjusted to take account of the effect of other possible outcomes.

### Question 5

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 one year from the date of sale. On the basis of experience, it is probable (ie more likely than not) that there will be some claims under the warranties.

Sales of CU10 million were made evenly throughout 20X1.

At 31 December 20X1 the expenditures for warranty repairs and replacements for the product sold in 20X1 are expected to be made 50 per cent in 20X1 and 50 per cent in 20X2. Assume for simplicity that all the 20X2 outflows of economic benefits related to the warranty repairs and replacements take place on 30 June 20X2.

Experience indicates that 95 per cent of products sold require no warranty repairs; 3 per cent of products sold require minor repairs costing 10 per cent of the sale price; and 2 per cent of products sold require major repairs or replacement costing 90 per cent of sale price. The entity has no reason to believe future warranty claims will be different from its experience.

At 31 December 20X1 the appropriate discount factor for cash flows expected to occur on 30 June 20X2 is 0.95238. Furthermore, an appropriate risk adjustment factor to reflect the uncertainties in the cash flow estimates is an increment of 6 per cent to the probability-weighted expected cash flows.

At 31 December 20X1 the entity recognises a warranty provision measured at:

- (a) CU0.
- (b) CU210,000.
- (c) CU222,600.
- (d) CU111,300.
- (e) CU106,000.

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### Question 6

An entity is the defendant in a patent infringement lawsuit. The entity's lawyers believe there is a 30 per cent chance that the court will dismiss the case and the entity will incur no outflow of economic benefits. However, if the court rules in favour of the claimant, the lawyers believe that there is a 20 per cent chance that the entity will be required to pay damages of CU200,000 (the amount sought by the claimant) and an 80 per cent chance that the entity will be required to pay damages of CU100,000 (the amount that was recently awarded by the same judge in a similar case). Other outcomes are unlikely.

The court is expected to rule in late December 20X2. There is no indication that the claimant will settle out of court.

A 7 per cent risk adjustment factor to the probability-weighted expected cash flows is considered appropriate to reflect the uncertainties in the cash flow estimates.

An appropriate discount rate is 10 per cent per year.

At 31 December 20X1 the entity recognises a provision for the lawsuit measured at:

- (a) CU0.
- (b) CU100,000.
- (c) CU89,880.
- (d) CU81,709.

### Question 7

The facts are the same as in Question 6. However, in this question, because of extremely rare circumstances disclosure of some of the information about the case required by paragraphs 21.14–21.16 can be expected to prejudice seriously the position of the entity in the dispute over the alleged breach of patent.

At 31 December 20X1 the entity would:

- (a) not recognise a provision and disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.
- (b) recognise a provision measured at the amount determined in Question 6 and disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.
- (c) recognise a provision measured at the amount determined in Question 6 and disclose the information required by paragraphs 21.14–21.16.

### Question 8

The facts are the same as in Question 6. However, in this question, the entity's lawyers believe there is a 60 per cent chance that the court will dismiss the case and the entity will incur no outflow. At 31 December 20X1, the entity:

- (a) recognises a provision measured at CU100,000.
- (b) recognises a provision measured at CU48,000.
- (c) recognises a provision measured at CU46,691.
- (d) discloses a contingent liability (and does not recognise a provision in its statement of financial position).



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### Question 9

On 20 February 20X5, before an entity's 31 December 20X4 financial statements were authorised for issue, a court ordered the entity to pay CU120,000 damages in full and final settlement of a patent infringement lawsuit brought against the entity by one of its competitors. The patent infringement occurred in 20X3. The amount of damages awarded to the competitor was significantly higher than the CU10,000–CU30,000 that the entity had justifiably expected to pay throughout the duration of the case. The entity will not contest the judgement.

In its 31 December 20X3 annual financial statements the entity reported its liability for the lawsuit at CU20,000—this estimate was *appropriately* made taking account of all available evidence at the time the financial statements were authorised for issue.

In its 31 December 20X4 financial statements the entity:

- (a) restates the comparative information as at 31 December 20X3 (ie retrospective restatement of a prior period error).
- (b) measures the provision as at 31 December 20X4 at CU120,000 (comparative information 20X3: CU20,000) (ie it is a change in accounting estimate in its 20X4 financial statements).
- (c) measures the provision as at 31 December 20X4 at CU20,000 (comparative information 20X3: CU20,000) and record the effect of the higher than expected settlement in profit or loss for the year ended 31 December 20X5 (ie account prospectively for the change in accounting estimate in the period that the final settlement amount was determined).

### Question 10

At 31 December 20X1 an entity is pursuing a claim against an insurance company through legal processes. The court is expected to rule in late December 20X2. At the reporting date (31 December 20X1) the outcome of the case is uncertain.

The entity's lawyers believe there is a 70 per cent chance that the entity will win the case. Furthermore, they believe that there is a 20 per cent chance that the entity will be awarded CU200,000 (the amount sought by the entity) and an 80 per cent chance that the entity will be awarded CU100,000 (the amount that was recently awarded by the same judge in a similar case). Other outcomes are unlikely.

A 7 per cent risk adjustment factor to the probability-weighted expected cash flows is considered appropriate to reflect the uncertainties in the cash flow estimates.

An appropriate discount rate is 10 per cent per year.

At 31 December 20X1 the entity:

- (a) recognises an asset measured at CU100,000.
- (b) recognises an asset measured at CU84,000.
- (c) recognises a contingent asset measured at CU81,709.
- (d) discloses a contingent asset (and does not recognise an asset in its statement of financial position).

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### Answers

- Q1 (a) reason—see paragraph 21.1
- Q2 (d) reason—see paragraph 21.4
- Q3 (a) reason—see paragraph 21.7(a)
- Q4 (c) reason—see paragraph 21.7(b)
- Q5 (e) calculation— $\text{CU}30,000 + \text{CU}180,000 = \text{CU}210,000$  expected value.  $\text{CU}210,000 \times 1.06$  risk adjustment =  $\text{CU}222,600$ .  $\text{CU}222,600 \times 50\%$  to be settled in 20X2 =  $\text{CU}111,300$ .  $\text{CU}111,300 \times 0.95238$  discount factor for 6 months =  $\text{CU}106,000$ .
- Q6 (d) calculation— $\text{CU}28,000$  (ie  $70\%$  chance that outcome will occur  $\times 20\% \times \text{CU}200,000$ ) +  $\text{CU}56,000$  (ie  $70\%$  chance that outcome will occur  $\times 80\% \times \text{CU}100,000$ ) =  $\text{CU}84,000$  expected value.  $\text{CU}84,000 \times 1.07$  risk adjustment =  $\text{CU}89,880$ .  $\text{CU}89,880 \div 1.1$  discount factor =  $\text{CU}81,709$ .
- Q7 (b) reason—see paragraph 21.17
- Q8 (d) reason—see paragraph 21.15
- Q9 (b) The court order is an adjusting event (see paragraph 32.5(a)).
- Q10 (d) reason—see paragraph 21.16.

# Module 21 – Provisions and Contingencies

## APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting provisions, contingent assets and contingent liabilities in accordance with the *IFRS for SMEs* by solving the case studies below.

Once you have completed the case studies check your answers against those set out below this test.

### Case study 1

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

At 31 December 20X1 SME A appropriately recognised CU50,000 warranty provision. SME A incurred and charged CU140,000 against the warranty provision in 20X2. CU80,000 of this related to warranties for sales made in 20X2. The increase during 20X2 in the discounted amount recognised as a provision at 31 December 20X2 arising from the passage of time is CU2,000.

At 31 December 20X2 SME A estimated that it would incur expenditures in 20X3 to meet its warranty obligations at 31 December 20X2, as follows:

- 5 per cent probability of CU400,000
- 20 per cent probability of CU200,000
- 50 per cent probability of CU80,000
- 25 per cent probability of CU20,000.

Assume for simplicity that the 20X3 cash flows for warranty repairs and replacements take place, on average, on 30 June 20X3.

An appropriate discount rate is 10 per cent per year. An appropriate risk adjustment factor to reflect the uncertainties in the cash flow estimates is an increment of 6 per cent to the probability-weighted expected cash flows.

SME A is also the defendant in a breach of patent lawsuit. Its lawyers believe there is a 70 per cent chance that SME A will successfully defend the case. However, if the court rules in favour of the claimant, the lawyers believe that there is a 60 per cent chance that the entity will be required to pay damages of CU2 million (the amount sought by the claimant) and a 40 per cent chance that the entity will be required to pay damages of CU1 million (the amount that was recently awarded by the same judge in a similar case). Other amounts of damages are unlikely.

The court is expected to rule in late December 20X3. There is no indication that the claimant will settle out of court.

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A 7 per cent risk adjustment factor to the cash flows is considered appropriate to reflect the uncertainties in the cash flow estimates.

An appropriate discount rate is 10 per cent per year

**Prepare accounting entries to record the provision in the accounting records of SME A for the year ended 31 December 20X2.**

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## Answer to case study 1

### In 20X2

Dr Profit or loss (finance cost)	CU2,000	
Cr Provision (warranties)		CU2,000

To recognise the unwinding of the discount in 20X2 on the warranty provision recognised at 20X1.

Dr Provision (warranties)	CU52,000 <sup>(a)</sup>	
Dr Profit or loss (warranties for 20X1 sales)	CU8,000 <sup>(b)</sup>	
Dr Profit or loss (warranties for 20X2 sales)	CU80,000	
Cr Cash		CU140,000

To recognise expenditure on warranties in 20X2.

### At 31 December 20X2

Dr Profit or loss (warranties)	CU106,000 <sup>(c)</sup>	
Cr Provision (warranties)		CU106,000

To recognise the warranty provision at 31 December 20X2.

### The calculations and explanatory notes below do not form part of the answer to this case study:

- (a) Balance at 31 December 20X1 of CU50,000 plus the increase in that amount due to the passage of time of CU2,000 = CU52,000
- (b) An additional profit or loss charge relating to 20X1 warranties because the provision made was CU52,000, but the actual amount incurred and charged relating to 20X1 warranties was CU60,000 (Total amount charged in the year less that relating to warranties for 20X2 sales = CU140,000 less CU80,000 = CU60,000), ie CU60,000 less CU52,000 = CU8,000
- (c) Carrying amount of the warranties provision at 31 December 20X2:

Probability-weighted expected cash flows	Including 6% risk adjustment	Discount rate	Discount factor	Present value
CU105,000 <sup>(d)</sup>	CU111,300	10% per year	0.95238 (at 5% for 6 months)	CU106,000

- (d) Probability-weighted expected cash flows:

CU400,000 × 5% =	CU20,000
CU200,000 × 20% =	CU40,000
CU80,000 × 50% =	CU40,000
CU20,000 × 25% =	CU5,000
Total	CU105,000

Note: Taking account of all of the available evidence, it is probable that SME A will successfully defend the court case. Therefore, SME A has a possible obligation and hence a contingent liability. There are no journal entries for the court case that SME A is defending—no amounts are recognised for contingent liabilities (see paragraph 21.12). However, disclosure is necessary (see paragraph 21.15).

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## Case study 2

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Facts are the same as in case study 1.

**Draft an extract showing how provisions and contingent liabilities could be presented and disclosed in the consolidated financial statements of SME A for the year ended 31 December 20X2.**

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## Answer to case study 2

Extract from SME A consolidated statement of financial position at 31 December 20X2:

### Note 1 Accounting policies

#### Provisions

A provision is recognised when the entity has a present obligation at the reporting date as a result of a past event and it is probable that settlement will require the transfer of economic benefits and the amount of the obligation can be estimated reliably. A provision is measured at the best estimate of the amount required to settle the obligation at the reporting date. The best estimate is the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at a time. It is determined using probability-weighted expected cash flows adjusted to reflect the uncertainties in the cash flow estimates and discounted using a pre-tax risk-free discount rate based on government bonds with the same term as the expected cash outflows to reflect the time value of money.

### Note 20 Provisions

A provision is recognised for expected claims on products sold with a one-year warranty. The entity undertakes to make good, by repair or replacement, manufacturing defects that become apparent within one year from the date of sale. The carrying amount of the warranty provision is estimated at the end of the financial reporting period using probability-weighted expected values based on experience taking into account any circumstances that have affected product quality.

The provision for warranties is analysed as follows:

<i>Description</i>	<i>Warranties (CU)</i>
Carrying amount at 31 December 20X1	50,000
Unwinding of the discount	2,000
Additions relating to previous year	8,000
Additions relating to current year	186,000
Settled in the period	(140,000)
Unused amounts reversed	-
Carrying amount at 31 December 20X2	106,000
Analysed as follows:	
Current	106,000
Non-current	-
	106,000

### Note 21 Contingent liabilities

In 20X2, legal proceedings were instigated against SME A for breach of patent. The claimant is seeking CU2 million compensation for the alleged breach. Management has sought legal advice in this matter and believes the claim does not have merit. The entity's lawyers are confident that the court will rule in favour of SME A and that no amount of damages will be awarded to the claimant.

No amount is recognised in the financial statements for this possible liability, the existence of which is dependent upon the outcome of the legal proceedings.