

12

PROVISIONS,
CONTINGENT LIABILITIES
AND CONTINGENT ASSETS

FINANCIAL REPORTING
STANDARD



ACCOUNTING
STANDARDS
BOARD

12

PROVISIONS,
CONTINGENT LIABILITIES
AND CONTINGENT ASSETS



ACCOUNTING
STANDARDS
BOARD

Financial Reporting Standard 12 is set out in paragraphs 1-102.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraph 2 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix VII 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on the FRS.

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ADOPTION OF FRS 12 BY THE BOARD

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SUMMARY

General

- a Financial Reporting Standard 12 'Provisions, Contingent Liabilities and Contingent Assets' sets out the principles of accounting for provisions, contingent liabilities and contingent assets. Its objective is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

Definitions

- b In the FRS a *provision* is a liability that is of uncertain timing or amount, to be settled by the transfer of economic benefits. A *contingent liability* is either (i) a possible obligation arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control; or (ii) a present obligation that arises from past events but is not recognised because it is not probable that a transfer of economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability. A *contingent asset* is a possible asset arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control.

Scope

- c The FRS applies to all financial statements that are intended to give a true and fair view in accounting for provisions, contingent liabilities and contingent assets except:
- those resulting from financial instruments that are carried at fair value
 - those resulting from executory contracts, except where the contract is onerous
 - those arising in insurance entities from contracts with policy-holders
 - those covered by more specific requirements in another FRS or a SSAP.

Recognition*Provisions*

- d A provision should be recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable that a transfer of economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met, no provision should be recognised.

Present obligation

- e Where it is not clear whether a present obligation exists, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

Past event

- f For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This will be the case only where the settlement of the obligation can be enforced by law or, in the case of a constructive obligation, the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation. The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date. Where an entity can avoid future expenditure by its future actions, for example by changing its method of operation, it has no present liability for that future expenditure and no provision is recognised.
- g An event that does not immediately give rise to an obligation may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted.

Probable transfer of economic benefits

- h For a liability to qualify for recognition there must be not only a present obligation but also the probability of a transfer of economic benefits to settle that obligation. A transfer of economic benefits in settlement of an obligation is regarded as probable if the outflow is more likely than not to occur. Where there are a number of similar obligations (eg product warranties or similar contracts) the probability that a transfer will be required in settlement is determined by considering the class of obligations as a whole.

Reliable estimate of the obligation

- i An entity will normally be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is therefore disclosed as a contingent liability.

Contingent liabilities

- j An entity should not recognise a contingent liability.

Contingent assets

- k An entity should not recognise a contingent asset.

Measurement*Best estimate*

- l The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under SSAP 15 'Accounting for deferred tax'.

Risks and uncertainties

- m The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of the amount of the provision. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

Present value

- n Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Future events

- o Future events that may affect the amount required to settle the entity's obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted.

Expected disposal of assets

- p Gains from the expected disposal of assets should not be taken into account in measuring a provision. Instead such gains are assessed for recognition under the principles of asset recognition, which include the requirements in FRS 11 'Impairment of Fixed Assets and Goodwill'.

Reimbursements

- q Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed that of the provision. In the profit and loss account, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

Changes in provisions

- r Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision should be reversed.
- s Where discounting is used, the size of a provision will change in each period to reflect the passage of time. This change is recognised as interest expense and disclosed separately from other interest on the face of the profit and loss account.

Use of provisions

- t A provision should be used only for expenditures for which the provision was originally recognised.

Disclosure

- u For each class of provision, an entity should disclose:
 - the carrying amount at the beginning and end of the period
 - additional provisions made in the period, including increases to existing provisions
 - amounts used (ie incurred and charged against the provision)
 - amounts reversed unused
 - the change in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information need not be disclosed for these items. In addition the entity should give:

- (i) a brief description of the nature of the obligation, and the expected timing of any resulting outflows of economic benefits;
- (ii) an indication of the uncertainties about the amount or timing of those outflows; and
- (iii) the amount of any reimbursement, and of any asset that has been recognised for that expected reimbursement.

- v Unless the possibility of any transfer in settlement is remote, for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability should be disclosed and, where practicable, an estimate of its financial effect and an indication of the uncertainties relating to the amount or timing of any outflow. The entity should also disclose the possibility of any reimbursement.
- w Where an inflow of economic benefits is probable, the entity should give a brief description of the nature of the contingent assets at the balance sheet date and, where practicable, an estimate of their financial effect.
- x In extremely rare cases, disclosure of some or all of the information required 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 the information need not be disclosed; but the general nature of the dispute should be disclosed, together with the fact that, and reason why, the information has not been disclosed.

FINANCIAL REPORTING STANDARD 12

Objective

- 1 The objective of this FRS is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

Definitions

- 2 The following definitions shall apply in the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type**.

Constructive obligation:-

An obligation that derives from an entity's actions where:

- (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 certain 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.

Contingent asset:-

A possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control.

Contingent liability:-

- (a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control; or
- (b) a present obligation that arises from past events but is not recognised because:
 - (i) it is not probable that a transfer of economic benefits will be required to settle the obligation; or
 - (ii) the amount of the obligation cannot be measured with sufficient reliability.

Legal obligation:-

An obligation that derives from:

- (a) a contract (through its explicit or implicit terms);
- (b) legislation; or
- (c) other operation of law.

Liabilities:-

Obligations of an entity to transfer economic benefits as a result of past transactions or events.

Obligating event:-

An event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Onerous contract:-

A contract in which the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received under it.

Provision:-

A liability of uncertain timing or amount.

Restructuring:-

A programme that is planned and controlled by management, and materially changes either:

- (a) the scope of a business undertaken by an entity; or
- (b) the manner in which that business is conducted.

Scope

- 3 The FRS applies to all financial statements that are intended to give a true and fair view in accounting for provisions, contingent liabilities and contingent assets, except:**

- (a) **those resulting from financial instruments that are carried at fair value;**
 - (b) **those resulting from executory contracts, except where the contract is onerous;**
 - (c) **those arising in insurance entities from contracts with policy-holders; or**
 - (d) **those covered by another FRS or a Statement of Standard Accounting Practice (SSAP).**
- 4 **Reporting entities applying the Financial Reporting Standard for Smaller Entities (FRSSE) are exempt from the FRS.**
 - 5 The FRS applies to financial instruments (including guarantees) that are not carried at fair value.
 - 6 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. The FRS does not apply to executory contracts unless they are onerous.
 - 7 The FRS applies to provisions, contingent liabilities and contingent assets of insurance entities other than those arising from contracts with policy-holders.
 - 8 Where another FRS or a SSAP deals with a more specific type of provision, contingent liability or contingent asset, an entity applies that standard instead of this FRS. For example, certain types of provisions are also addressed in standards on:

- long-term contracts (see SSAP 9 'Stocks and long-term contracts').
 - deferred tax (see SSAP 15 'Accounting for deferred tax').
 - leases (see SSAP 21 'Accounting for leases and hire purchase contracts'). However, as SSAP 21 contains no specific requirements to deal with operating leases that have become onerous, the FRS applies to such cases.
 - pension costs (see SSAP 24 'Accounting for pension costs').
- 9 The FRS defines provisions as liabilities of uncertain timing or amount. The term 'provision' is also used sometimes in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in the FRS.
- 10 The FRS applies to provisions for restructuring (including discontinued operations). Where a restructuring meets the definition of a discontinued operation, additional disclosures may be required by FRS 3 'Reporting Financial Performance'.

Provisions and other liabilities

- 11 Provisions can be distinguished from other liabilities such as trade creditors and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. By contrast:

- (a) trade creditors are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and
- (b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example amounts relating to accrued holiday pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Accruals are often reported as part of trade and other creditors, whereas provisions are reported separately.

Relationship between provisions and contingent liabilities

- 12 In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, in the FRS the term “contingent” is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity’s control. In addition, the term “contingent liability” is used for liabilities that do not meet the recognition criteria.

- 13 The FRS distinguishes between:
- (a) provisions—which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations where it is probable that a transfer of economic benefits will be required to settle the obligations; and
 - (b) contingent liabilities—which are not recognised as liabilities because they are either:
 - (i) possible obligations, as it has yet to be confirmed whether the entity has an obligation that could lead to a transfer of economic benefits; or
 - (ii) present obligations that do not meet the recognition criteria in the FRS because either it is not probable that a transfer of economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made.

Recognition

PROVISIONS

- 14 **A provision should be recognised when:**
- (a) an entity has a present obligation (legal or constructive) as a result of a past event;**
 - (b) it is probable that a transfer of economic benefits will be required to settle the obligation; and**

(c) a reliable estimate can be made of the amount of the obligation.

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

Present obligation

- 15 **In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.**
- 16 In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events occurring after the balance sheet date. On the basis of such evidence:
 - (a) where it is more likely than not that a present obligation exists at the balance sheet date, the entity recognises a provision (if the recognition criteria are met); and
 - (b) where it is more likely that no present obligation exists at the balance sheet date, the entity discloses a contingent liability, unless the possibility of a transfer of economic resources is remote (see paragraph 91).

Past event

- 17 A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:
 - (a) where the settlement of the obligation can be enforced by law; or
 - (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.
- 18 Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date.
- 19 It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to a transfer of economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future

actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

- 20 An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the balance sheet date unless the decision has been communicated before the balance sheet date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.
- 21 An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.
- 22 Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted. For the purposes of the FRS, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable transfer of economic benefits

- 23 For a liability to qualify for recognition there must be not only a present obligation but also the probability of a transfer of economic benefits to settle that obligation. For the purpose of the FRS, a transfer of economic benefits or other event is regarded as probable if the event is more likely than not to occur, ie the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of a transfer of economic resources is remote (see paragraph 91).
- 24 Where there are a number of similar obligations (eg product warranties or similar contracts) the probability that a transfer will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some transfer of economic benefits will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable estimate of the obligation

- 25 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 balance sheet items. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.
- 26 In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 91).

CONTINGENT LIABILITIES

- 27 **An entity should not recognise a contingent liability.**
- 28 A contingent liability is disclosed, as required by paragraph 91, unless the possibility of a transfer of economic benefits is remote.
- 29 Where 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. The entity recognises a provision for the part of the obligation for which a transfer of economic benefits is probable (except in the extremely rare circumstances where no reliable estimate can be made).
- 30 Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether a transfer of economic benefits has become probable. If it becomes probable that a transfer of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

CONTINGENT ASSETS

- 31 **An entity should not recognise a contingent asset.**
- 32 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. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

- 33 Contingent assets are not recognised in financial statements because it could result in the recognition of profit that may never be realised. However, when the realisation of the profit is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- 34 A contingent asset is disclosed, as required by paragraph 94, where an inflow of economic benefits is probable.
- 35 Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related profit are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset (see paragraph 94).

Measurement

Best estimate

- 36 **The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.**
- 37 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 balance sheet date or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the balance sheet date. 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 balance sheet date.

- 38 The estimates of outcome and financial effect are determined by the judgement of the entity's management, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered will include any additional evidence provided by events after the balance sheet date.
- 39 Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'. 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.

Example

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of £1 million would result. If major defects were detected in all products sold, repair costs of £4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75 per cent of the goods sold will have no defects, 20 per cent of the goods sold will have minor defects and 5 per cent of the goods sold will have major defects. In accordance with paragraph 24 an entity assesses the probability of a transfer for the warranty obligations as a whole.

The expected value of the cost of repairs is:
 $(75\% \text{ of nil}) + (20\% \text{ of } £1\text{m}) + (5\% \text{ of } £4\text{m}) =$
 £400,000

- 40 Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where 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. For example, if an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of £1 million but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

- 41 The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under SSAP 15 'Accounting for deferred tax'.

Risks and uncertainties

- 42 **The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.**
- 43 Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that profit or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.
- 44 Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 90(b).

Present value

- 45 **Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.**

- 46 Because of the time value of money, provisions relating to cash outflows that arise soon after the balance sheet date are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.
- 47 **The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.**
- 48 **The unwinding of the discount should be included as a financial item adjacent to interest but should be shown separately from other interest either on the face of the profit and loss account or in a note.**
- 49 Using a discount rate that reflects current market assessments of the time value of money and the risks specific to the liability is a method of reflecting the risk associated with the cash flows in the present value calculation. It is likely that this method will be the easiest method of reflecting risk. However, an acceptable alternative is to adjust the cash flows for risk and to discount them using a risk-free rate (eg a government bond rate). Whichever method of reflecting risk is adopted, care must be taken that the effect of risk is not double-counted by inclusion in both the cash flows and the discount rate.
- 50 If the cash flows to be discounted are expressed in current prices, a real discount rate will be used. If the cash flows are expressed in expected future prices, a nominal discount rate will be used.

Future events

- 51 **Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.**
- 52 Expected future events may be particularly important in measuring provisions. For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.
- 53 The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Expected disposal of assets

- 54 Gains from the expected disposal of assets should not be taken into account in measuring a provision.**
- 55 Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity assesses such gains for recognition under the principles of asset recognition, which include the requirements in FRS 11 'Impairment of Fixed Assets and Goodwill'.

Reimbursements

- 56 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.**
- 57 In the profit and loss account, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.**
- 58 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.

- 59 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, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.
- 60 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.
- 61 As noted in paragraph 29, 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.

Changes in provisions

- 62 **Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision should be reversed.**
- 63 Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. As required in paragraph 48, this increase is recognised as an interest expense.

Use of provisions

- 64 **A provision should be used only for expenditures for which the provision was originally recognised.**
- 65 Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Recognising an asset when recognising a provision

- 66 **When a provision or a change in a provision is recognised, an asset should also be recognised when, and only when, the incurring of the present obligation recognised as a provision gives access to future economic benefits; otherwise the setting up of the provision should be charged immediately to the profit and loss account.**
- 67 Where a provision is recognised for a present obligation that has been incurred to gain rights or other access to future economic benefits that are to be enjoyed over more than one period, the part of the provision incurred that relates to such future benefits is capitalised. For example, an obligation for decommissioning costs is incurred by commissioning an oil rig but the commissioning also gives access to oil reserves over the years of the oil rig's operation—an asset representing future access to oil reserves is therefore recognised at the same time as the provision for decommissioning costs.

Application of the recognition and measurement rules***Future operating losses*****68 Provisions should not be recognised for future operating losses.**

69 Future operating losses do not meet the definition of a liability in paragraph 2 and the general recognition criteria set out for provisions in paragraph 14.

70 An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity tests these assets for impairment under FRS 11.

Onerous contracts**71 If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision.**

72 Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of the FRS and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of the FRS.

73 The FRS defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, ie the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

- 74 Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract.

Restructuring

- 75 The following are examples of events that may fall under the definition of restructuring:
- (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.
- 76 A provision for restructuring costs is recognised only when the general recognition criteria for provisions set out in paragraph 14 are met. Paragraphs 77-88 set out how those criteria apply to restructurings.

77 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.

78 Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (ie setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

- 79 For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.
- 80 A management or board decision to restructure taken before the balance sheet date does not give rise to a constructive obligation at the balance sheet date unless the entity has, before the balance sheet date:
- (a) started to implement the restructuring plan; or
 - (b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

In some cases the entity starts to implement the restructuring plan, or announces its main features to those affected by it, only after the balance sheet date. Disclosure may be required under SSAP 17 'Accounting for post balance sheet events' if the restructuring is of such importance that its non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.

- 81 Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of paragraph 77 are met.
- 82 In some countries the ultimate authority is vested in a board whose membership includes representatives of interests other than management (eg employees); alternatively, notification to such representatives may be necessary before the board decision is taken. Because a decision by the board in these circumstances involves communication to these representatives, it may result in a constructive obligation to restructure.
- 83 **No obligation arises for the sale of an operation until the entity is committed to the sale, ie there is a binding sale agreement.**
- 84 Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is such an agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment, under FRS 11. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

85 A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

- (a) necessarily entailed by the restructuring and**
- (b) not associated with the ongoing activities of the entity.**

86 A restructuring provision does not include such costs as:

- (a) retraining or relocating continuing staff;
- (b) marketing; or
- (c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

87 Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract as defined in paragraph 2.

88 As required by paragraph 54, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

- 89 For each class of provision, an entity should disclose:**
- (a) the carrying amount at the beginning and end of the period;**
 - (b) additional provisions made in the period, including increases to existing provisions;**
 - (c) amounts used (ie incurred and charged against the provision) during the period;**
 - (d) unused amounts reversed during the period; and**
 - (e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.**

Comparative information is not required.

- 90 An entity should disclose the following for each class of provision:**
- (a) a brief description of the nature of the obligation, and the expected timing of any resulting transfers of economic benefits;**
 - (b) an indication of the uncertainties about the amount or timing of those transfers of economic benefits. Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events, as addressed in paragraph 51; and**

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

91 Unless the possibility of any transfer in settlement is remote, an entity should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured in accordance with paragraphs 36-55;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

92 In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraph 90(a) and (b) or 91(a) and (b). Thus it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

93 Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by paragraphs 89-91 in a way that shows the link between the provision and the contingent liability.

- 94 **Where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the balance sheet date and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-55.**
- 95 It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of a profit arising.
- 96 **Where any of the information required by paragraphs 91 and 94 is not disclosed because it is not practicable to do so, that fact should be stated.**
- 97 In extremely rare cases, disclosure of some or all of the information required by paragraphs 89-94 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, unless its disclosure is required by law; but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Date from which effective

- 98 The accounting practices set out in the FRS should be regarded as standard in respect of financial statements relating to accounting periods ending on or after 23 March 1999. Earlier adoption is encouraged but not required.

Withdrawal of SSAP 18 and amendment of FRS 3

- 99 **The FRS supersedes SSAP 18 ‘Accounting for contingencies’.**
- 100 **In FRS 3 ‘Reporting Financial Performance’ paragraph 18 is amended as follows:**
- (a) in the first sentence the words “or the disposal of its assets” are deleted.**
 - (b) in the fourth sentence the words “or disposal of its assets” are deleted.**

Application of the new requirements

- 101 **Changes in accounting policy arising from the initial application of the FRS should be dealt with as prior period adjustments in accordance with FRS 3 (paragraphs 7, 29 and 62). Corrections of accounting estimates should be dealt with in the profit and loss account of the period of initial application, and their effect stated where material (FRS 3, paragraph 60).**
- 102 The initial application of the FRS will in some circumstances entail a change in accounting policy, and, in other cases, a correction of accounting estimate. For example, where no provision was previously recognised for decommissioning costs but the FRS requires that a provision is recognised, or where a provision was previously recognised that is not permitted by the FRS (for example, a provision for self-insurance), the application of the recognition principles set out in the FRS is a change in accounting policy. In contrast, where, for example, an entity already provides for its warranties but the initial application of the FRS causes the provision to be measured at a different amount, the change is a change in accounting estimate.

ADOPTION OF FRS 12 BY THE BOARD

Financial Reporting Standard 12 - 'Provisions, Contingent Liabilities and Contingent Assets' was approved for issue by the ten members of the Accounting Standards Board.

Sir David Tweedie (Chairman)

Allan Cook (Technical Director)

David Allvey

Ian Brindle

Dr John Buchanan

John Coombe

Raymond Hinton

Huw Jones

Professor Geoffrey Whittington

Ken Wild

APPENDIX I

TABLES: MAIN REQUIREMENTS OF THE FRS

This appendix summarises the main requirements of the FRS. It does not form part of the FRS and should be read in the context of the full text.

Provisions and contingent liabilities

Where, as a result of past events, there may be a transfer of future economic benefits in settlement of (a) a present obligation or (b) a possible obligation whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control, and		
there is a present obligation that probably requires a transfer of economic benefits in settlement,	there is a possible obligation or a present obligation that may, but probably will not, require a transfer of economic benefits in settlement,	there is a possible obligation or a present obligation where the likelihood of a transfer of economic benefits in settlement is remote,
a provision is recognised (paragraph 14); and disclosures are required for the provision (paragraphs 89 and 90).	no provision is recognised (paragraph 27); but disclosures are required for the contingent liability (paragraph 91).	no provision is recognised (paragraph 27); and no disclosure is required (paragraph 91).

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably (paragraph 2). Disclosures are required for the contingent liability (paragraph 91).

Contingent assets

Where, as a result of past events, there is a possible asset whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control, and		
the inflow of economic benefits is virtually certain,	the inflow of economic benefits is probable but not virtually certain,	the inflow is not probable,
the asset is not contingent (paragraph 33).	no asset is recognised (paragraph 31); but disclosures are required (paragraph 94).	no asset is recognised (paragraph 31); and no disclosure is required (paragraph 94).

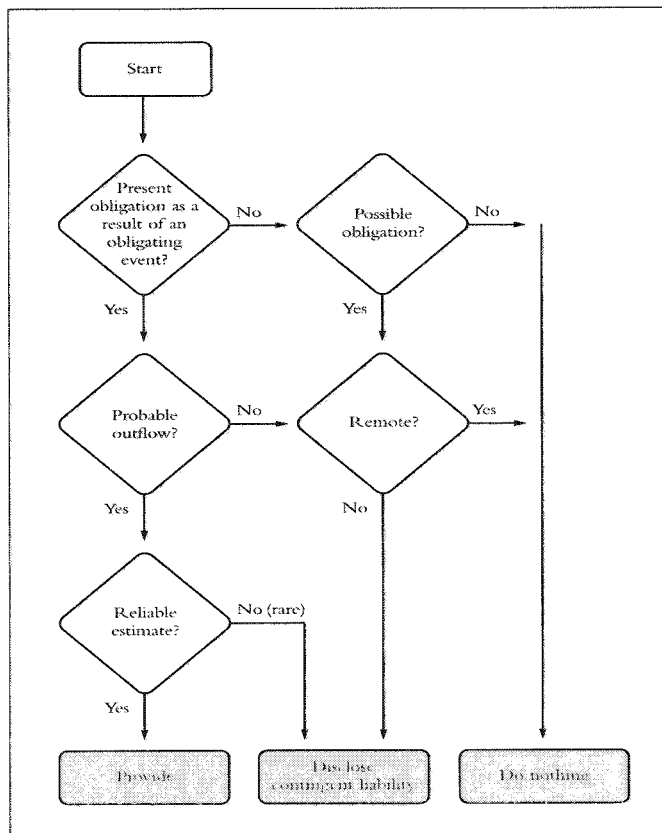
Reimbursements

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, and		
the entity has no obligation for the part of the expenditure to be reimbursed by the other party,	the obligation for the amount expected to be reimbursed remains with the entity and it is virtually certain that reimbursement will be received if the entity settles the provision,	the obligation for the amount expected to be reimbursed remains with the entity and the reimbursement is not virtually certain if the entity settles the provision,
<p>the entity has no liability for the amount to be reimbursed (paragraph 60); and</p> <p>no disclosure is required.</p>	<p>the reimbursement is recognised as a separate asset in the balance sheet and may be offset against the charge in the profit and loss account. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 56 and 57); and</p> <p>the reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 90(c)).</p>	<p>the expected reimbursement is not recognised as an asset (paragraph 56); but</p> <p>the expected reimbursement is disclosed (paragraph 90(c)).</p>

APPENDIX II

DECISION TREE

This appendix summarises the main requirements of the FRS. It does not form part of the FRS and should be read in the context of the full text.



Note: in rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (see paragraph 15).

APPENDIX III

EXAMPLES: RECOGNITION

This appendix illustrates the application of the FRS to assist in clarifying its meaning. It does not form part of the FRS.

All the entities in the examples have 31 December year-ends. 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.

The cross-references in the examples are to paragraphs of the FRS that are particularly relevant. The appendix should be read in the context of the full text of the FRS.

References to “best estimate” are to the present value amount where the effect of the time value of money is material.

Example 1:***Warranties***

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 past 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.

Transfer of economic benefits in settlement—Probable for the warranties as a whole (see paragraph 24).

Conclusion—A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 24).

Example 2A:***Contaminated land – legislation virtually certain to be enacted***

An entity in the oil industry causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At 31 December it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end.

Present obligation as a result of a past obligating event—The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

Transfer of economic benefits in settlement—Probable.

Conclusion—A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 22).

Example 2B:***Contaminated land and constructive obligation***

An entity in the oil industry causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy.

Present obligation as a result of a past obligating event—The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

Transfer of economic benefits in settlement—Probable.

Conclusion—A provision is recognised for the best estimate of the costs of clean-up (see paragraphs 2 (the definition of a constructive obligation), 14 and 17).

Example 3:***Offshore oilfield***

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs of undertaking this work relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event—The construction of the oil rig creates a legal obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

Transfer of economic benefits in settlement—Probable.

Conclusion—A provision is recognised for the best estimate of the ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraphs 17–19). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Example 4:***Refunds policy***

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

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

Transfer of economic benefits in settlement—Probable, as a proportion of goods are returned for refund (see paragraph 24).

Conclusion—A provision is recognised for the best estimate of the costs of refunds (see paragraphs 2 (the definition of a constructive obligation), 14, 17 and 24).

Example 5A:***Closure of a division—no implementation before balance sheet date***

On 12 December 2000 the board of an entity decided to close down a division. Before the balance sheet date (31 December 2000) 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—No provision is recognised (see paragraphs 14 and 77).

Example 5B:***Closure of a division—communication/implementation before balance sheet date***

On 12 December 2000 the board of an entity decided to close down a division making a particular product. On 20 December 2000 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

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.

Transfer of economic benefits in settlement—Probable.

Conclusion—A provision is recognised at 31 December 2000 for the best estimate of the costs of closing the division (see paragraphs 14 and 77).

Example 6:***Legal requirement to fit smoke filters***

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 2000. The entity has not fitted the smoke filters.

(a) *At the balance sheet date of 31 December 1999*

Present obligation as a result of a past obligating event—There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion—No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14, 17 and 18).

(b) *At the balance sheet date of 31 December 2000*

Present obligation as a result of a past obligating event—There is still no obligation for the costs of fitting smoke filters because no obligating event (the fitting of the filters) has occurred. However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

Transfer of economic benefits in settlement—Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion—No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 17-19).

Example 7:***Staff retraining as a result of changes in the income tax system***

The government introduces a number of changes to the income tax system. As a result of these changes an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date no retraining of staff has taken place.

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

Conclusion—No provision is recognised (see paragraphs 14 and 17-19).

Example 8:***An onerous contract***

An entity operates profitably from a factory that it has leased under an operating lease. During December 2000 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event—The obligating event is the signing of the lease contract, which gives rise to a legal obligation.

Transfer of economic benefits in settlement—When the lease becomes onerous, a transfer of economic benefits is probable. (Until the lease becomes onerous, the entity accounts for the lease by applying SSAP 21 ‘Accounting for leases and hire purchase agreements’.)

Conclusion—A provision is recognised for the best estimate of the unavoidable lease payments (see paragraphs 14 and 71).

Example 9:***A single guarantee***

During 1999 Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 2000, the financial condition of Entity B deteriorates and at 30 June 2000 Entity B files for protection from its creditors.

(a) At 31 December 1999

Present obligation as a result of a past obligating event—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

Transfer of economic benefits in settlement—No transfer of benefits is probable at 31 December 1999.

Conclusion—No provision is recognised (see paragraphs 14 and 23). The guarantee is disclosed as a contingent liability unless the probability of any transfer is regarded as remote (see paragraph 91).

(b) At 31 December 2000

Present obligation as a result of a past obligating event—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

Transfer of economic benefits in settlement—At 31 December 2000 it is probable that a transfer of economic benefits will be required to settle the obligation.

Conclusion—A provision is recognised for the best estimate of the obligation (see paragraphs 14 and 23).

Note: This example deals with a single guarantee. If an entity has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether a transfer of economic benefit is probable (see paragraph 24). Where an entity gives guarantees in exchange for a fee, revenue is recognised only when earned.

Example 10:***A court case***

After a wedding in 2000 ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of approval of the financial statements for the year to 31 December 2000, 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 2001 its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable.

(a) At 31 December 2000

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 (see paragraphs 14–16). The matter is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

(b) At 31 December 2001

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

Transfer of economic benefits in settlement—Probable.

Conclusion—A provision is recognised for the best estimate of the amount needed to settle the present obligation (paragraphs 14–16).

Example 11:***Repairs and maintenance***

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components.

Example 11A:***Refurbishment costs—no legislative requirement***

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event—There is no present obligation.

Conclusion—No provision is recognised (see paragraphs 14 and 19).

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the entity's future actions—even the intention to incur the expenditure depends on the entity deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, ie it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Example 11B:***Refurbishment costs—legislative requirement***

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event—There is no present obligation.

Conclusion—No provision is recognised (see paragraphs 14 and 19).

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in example 11A. Even a legal requirement to overhaul does not make the costs of overhaul a liability because no obligation exists to overhaul the aircraft independently of the entity's future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, ie an amount equivalent to the expected maintenance costs is depreciated over three years.

Example 12:***Self-insurance***

An entity that operates a chain of retail outlets decides not to insure itself in respect of the risk of minor accidents to its customers: instead it will “self insure”. Based on its past experience, it expects to pay £100,000 a year in respect of these accidents. Should provision be made for the amount expected to arise in a normal year?

Present obligation as a result of a past obligating event—There is no present obligation.

Conclusion—No provision is recognised. There is no present obligation because there is no other party involved in insuring the risks (see paragraph 20).

APPENDIX IV

EXAMPLES: DISCLOSURES

These examples are illustrative only and do not form part of the FRS.

Examples 1 and 2 provide examples of the disclosures required by paragraph 90.

Example 1:

Warranties

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

“A provision of £60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that most of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.”

Example 2:**Decommissioning costs**

In 2000 an entity involved in nuclear activities recognises a provision for decommissioning costs of £300 million. The provision is estimated using the assumption that decommissioning will take place in 60-70 years' time. However, there is a possibility that it will not take place until 100-110 years' time, in which case the present value of the costs will be significantly reduced. The following information is disclosed:

“A provision of £300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2060 and 2070. However, there is a possibility that decommissioning will not take place until 2100-2110. If the costs were measured based upon the expectation that they would not be incurred until 2100-2110 the provision would be reduced to £136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2 per cent.”

Example 3 provides an example of the disclosures required by paragraph 97, where some of the information required is not given because it can be expected to prejudice seriously the position of the entity.

Example 3:

Disclosure exemption

An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of £100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 89 and 90. The following information is disclosed:

“Litigation is in process against the company relating to a dispute with a competitor which alleges that the company has infringed patents and which is seeking damages of £100 million. The information usually required by FRS 12 is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.”

APPENDIX V

NOTE ON LEGAL REQUIREMENTS

Great Britain

- 1 The statutory requirements on accounting for provisions and contingencies are set out in the Companies Act 1985. The main requirements that are directly relevant are set out in Schedules 4 and 4A and are summarised below.
- 2 Schedule 4 to the Act does not apply to banking and insurance companies and groups. Banking companies and groups are dealt with in Schedule 9 and insurance companies and groups are dealt with in Schedule 9A.
- 3 Paragraph 12(b) of Schedule 4 states the general requirement that “all liabilities and losses which have arisen or are likely to arise in respect of the financial year to which the accounts relate or a previous financial year shall be taken into account ...”
- 4 Provisions represent one aspect of the manner in which this general requirement is met. Provisions are defined in paragraph 89 of Schedule 4 in the following manner:

“References to provisions for liabilities or charges are to any amount retained as reasonably necessary for the purposes of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.”

The FRS defines a provision as:

“A liability of uncertain timing or amount.”

- 5 The requirements of the FRS are expressed in more specific terms than the requirements in Schedule 4. However, although the Act and the FRS define provisions in different terms, the Board believes that, when taken in their respective contexts, the FRS is consistent with the requirements of Schedule 4.
- 6 The legal definition refers to "... any amount retained as reasonably necessary for the purposes ...". The reference to reasonableness recognises that the appropriate amount to set aside as a provision for a specific matter will often be a matter of judgement. The FRS sets out the manner in which this judgement should be exercised in the context of giving a true and fair view.
- 7 In addition, the legal definition refers to "... any liability or loss ... [whether likely to be incurred or certain to be incurred]" and this needs to be considered in conjunction with the general requirement that "liabilities or losses have arisen or are likely to arise in respect of the financial year to which the accounts relate [or a previous financial year]" (paragraph 12(b) of Schedule 4). These requirements are consistent with the Board's approach of requiring there to be a past transaction or event that gives rise to an obligation, before a provision can be recognised. Without a past transaction or event the liability or loss will not have arisen or be likely to arise in respect of the financial year or a previous financial year. Before a liability can be recognised, the draft Statement of Principles for Financial Reporting* requires sufficient evidence that a future transfer of benefits will occur.

* *Exposure Draft, November 1995*

- 8 In addition to covering liabilities that are certain to be incurred, the statutory definition also refers to liabilities as losses that are “likely to be incurred”. This aspect of likelihood is covered in the FRS in two respects. The FRS requires provisions to be recognised arising from ‘constructive obligations’, which are liabilities that pass the test of sufficient certainty without constituting legal liabilities. The FRS also requires the recognition of provisions where a transfer of economic benefit is more likely than not to occur.
- 9 Where any amount is transferred to any provision for liabilities and charges or from any provision for liabilities and charges otherwise than for the purpose for which the provision was established, paragraph 46(1) and (2) of Schedule 4 requires the following information to be disclosed:
 - (a) the amount of the provisions as at the date of the beginning of the financial year and as at the balance sheet date respectively;
 - (b) any amounts transferred to or from provisions during that year; and
 - (c) the source and application respectively of any amounts so transferred.
- 10 Paragraph 46(3) of Schedule 4 requires particulars to be given of each material provision included in the item “other provisions” in the company’s balance sheet.

- 11 Paragraph 50(2) of Schedule 4 requires the following information to be given in respect of any other contingent liability not provided for:
- (a) the amount or estimated amount of that liability;
 - (b) its legal nature; and
 - (c) whether any valuable security has been provided by the company in connection with that liability and, if so, what.

Northern Ireland

- 12 The statutory requirements in Northern Ireland are set out in the Companies (Northern Ireland) Order 1986. They are identical to and parallel the references in the legislation for Great Britain cited above.

Republic of Ireland

- 13 The statutory requirements in the Republic of Ireland that correspond to those cited above for Great Britain are shown in the following table.

Great Britain

Schedule 4 to the
Companies Act 1985

Schedule 4A to the
Companies Act 1985

Schedule 9 to the
Companies Act 1985

Schedule 9A to the
Companies Act 1985

Paragraph 12(b) of Schedule 4
to the Companies Act 1985

Paragraph 89 of Schedule 4
to the Companies Act 1985

Paragraph 46(1) and (2) of
Schedule 4 to the Companies
Act 1985

Paragraph 46(3) of Schedule 4
to the Companies Act 1985

Paragraph 50(2) of Schedule 4
to the Companies Act 1985

Republic of Ireland

The Schedule to the Companies
(Amendment) Act 1986

Regulation 15(1) of the
European Communities
(Companies: Group Accounts)
Regulations 1992

European Communities (Credit
Institutions: Accounts)
Regulations 1992

European Communities
(Insurance Undertakings:
Accounts) Regulations 1996

Section 5(c)(ii) of the
Companies (Amendment)
Act 1986

Paragraph 70 of the Schedule to
the Companies (Amendment)
Act 1986

Paragraph 32(1) and (2) of the
Schedule to the Companies
(Amendment) Act 1986

Paragraph 32(3) of the Schedule
to the Companies (Amendment)
Act 1986

Paragraph 36(2) of the Schedule
to the Companies (Amendment)
Act 1986

APPENDIX VI

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

Because the FRS was developed jointly with the international standard on the same topic, IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', all the requirements of the IAS are included in the FRS and there are no differences of substance between these common requirements. The FRS, additionally, deals with the circumstances under which an asset should be recognised when a provision is recognised and gives more guidance than the IAS on the discount rate to be used in the present value calculation.

APPENDIX VII

THE DEVELOPMENT OF THE FRS

The need for a standard

- 1 Provisions often have a substantial effect on an entity's financial position and performance. They arise in a wide range of circumstances and businesses covering such matters as warranties, onerous contracts, restructuring costs, environmental liabilities and decommissioning costs. Published guidance on the subject, however, has tended to concentrate on particular forms of provision rather than the general principles underlying all provisions.
- 2 To portray the financial position of an entity, it is important that a provision should be recognised whenever a relevant liability exists; but it is equally important to recognise a provision only when such a liability exists. The basis of a liability is the existence of an obligation to one or more third parties. It follows that the *intention* to incur expenditure does not, of itself, result in a liability. This point needs to be made in an accounting standard because in some cases a mere intention to incur expenditure has been used to justify recognising a provision.
- 3 In the absence of an accounting standard on provisions the practice has grown up of aggregating liabilities with expected liabilities of future years, and sometimes even with expected expenditures related to ongoing operations, in one large provision, often reported as an exceptional item. The effect of such 'big bath' provisions has been not only to report excessive liabilities at the outset but also to boost profitability during the subsequent years, when the liabilities are in fact being incurred.

- 4 The FRS addresses these concerns, first by requiring that provisions should be recognised only where a liability exists at the period-end (based on the definition of a liability in FRS 5 'Reporting the Substance of Transactions' and in the Board's draft Statement of Principles for Financial Reporting*) and secondly by showing in examples how this principle should apply to a number of commonly occurring circumstances. The FRS deals with recognition, measurement and disclosure for provisions. Because contingent liabilities and contingent assets are closely linked to provisions, the FRS also covers their treatment.
- 5 The Board has taken the opportunity to develop a complete framework of disclosure requirements for provisions, contingent liabilities and contingent assets. The new disclosure requirements give information about the significance of a provision and any changes in it during the year and show how provisions have been used as expenditure occurs.
- 6 In developing the FRS, the Board has considered the comments on its proposals set out initially in the Discussion Paper 'Provisions' published in November 1995 and then in FRED 14 'Provisions and Contingencies' issued in June 1997. At both stages the majority of respondents have supported the issue of an FRS on provisions and the general principles proposed as its basis.

* *Exposure Draft, November 1995*

- 7 The FRS has been developed as part of a joint project with the International Accounting Standards Committee. The parallel development of the FRS and IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' has meant that each standard has been able to benefit from the comments and discussion on the other project. Apart from the two minor additions to the FRS noted in Appendix VI, the two standards are identical except for phraseology and structure necessary to conform to established practice in each constituency.

The general principles

- 8 The central principle of the FRS is that a provision should be recognised only where at the period-end a liability exists that can be measured reliably. An entity may feel less well-off at the prospect of future cash flows entailed by its method of operation from the moment it becomes aware that they are likely to be necessary—it may wish to communicate such prospects by a note—but future expenditure, however necessary, does not justify the recognition of a provision unless a liability exists at the period-end. For a liability to exist the entity must have, as a result of past transactions or events, an obligation to transfer economic benefits in settlement. Future expenditure not relating to present obligations should be recognised in the period when the obligation to incur that expenditure arises.

- 9 FRED 14 distinguished between a legal and a constructive obligation. The responses indicated that it would be helpful to clarify the concept of a constructive obligation as a present obligation arising otherwise than by operation of law. The essence of an obligation is commitment to a third party: for a constructive obligation, that commitment arises through actions of the entity—its establishing a pattern of practice, publishing its policies or making a current statement setting out in detail its intended future actions—that raise in those dealing with it or affected by it a valid expectation that the entity will discharge its responsibilities. A constructive obligation is often the basis for recognising a provision for restructuring. The examples deal also with whether a constructive obligation exists for habitual refunds, cleaning up contamination and the closure of a division.
- 10 The proposals in FRED 14 defined ‘contingency’ and dealt with contingent losses and contingent gains rather than contingent liabilities and contingent assets. The draft Statement of Principles deals with the recognition of assets and liabilities and therefore the FRS now bases its analysis on contingent liabilities and contingent assets.
- 11 The FRS has clarified the relationship between provisions and contingent liabilities, which was the source of some concern to those commenting on the FRED 14 proposals. FRED 14 proposed that some contingent losses should be recognised while others should not. Under the FRS contingent liabilities as defined never qualify for recognition as liabilities—if circumstances change and a provision needs to be recognised there is no longer a contingent liability.

- 12 Similarly, the effect of the definition of a contingent asset in the FRS is that nothing that meets the criteria for recognition as an asset will count as a contingent asset. This distinction is clearer than the equivalent proposal in FRED 14 that some contingent gains should be recognised while others should not.

Scope

- 13 FRED 14 proposed that the FRS should apply to all financial statements that are intended to give a true and fair view of the reporting entity's financial position and profit or loss for a period. This proposal was widely supported by the respondents. However, because the accounting framework for financial instruments is under review, the Board has decided to exclude financial instruments carried at market value from the scope of the FRS. The special regulatory position of insurance companies (for which provisions are particularly important) and the review of the accounting framework for insurance companies have led the Board to leave outside the scope of the FRS provisions arising in insurance entities from contracts with policy-holders. Because there are other accounting standards that specifically consider provisions in certain cases (eg pensions), the FRS does not apply to provisions covered by more specific requirements in other standards.

Recognition

A present obligation

- 14 As explained above, the FRS follows the general principle proposed in the Discussion Paper and FRED 14—and already embodied in FRS 3 ‘Reporting Financial Performance’ and FRS 7 ‘Fair Values in Acquisition Accounting’—that a provision should be recognised only where a liability exists that can be reliably estimated. The recognition criteria in the FRS therefore require that:
- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
 - (b) it is probable that a transfer of economic benefits will be required to settle the obligation; and
 - (c) a reliable estimate can be made of the amount of the obligation.

Conditions (a) and (b) must be fulfilled for a liability to exist. Condition (c) requires that it should be able to be measured with sufficient reliability. These conditions are therefore consistent with the recognition criteria set out in the draft Statement of Principles.

Past event

- 15 For there to be a present obligation the FRS requires that an obligating event has taken place. An obligating event creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. In FRED 14 the proposals for

recognition were also based on the existence of a present obligation, the key notion being that the entity had no realistic alternative to making a transfer of economic benefits. The Board decided that it would be helpful to include more guidance on the obligating event that gives rise to a present obligation. The FRS notes that it is only those obligations arising independently of the entity's future actions that are recognised as provisions. Where the entity can avoid future expenditure by its future actions, it has no present liability for that future expenditure and no provision is recognised. The examples in Appendix III illustrate the effect in practice of applying the FRS in assessing whether an obligating event has taken place—in particular examples 3 (offshore oilfield), 6 (smoke filters), 7 (staff retraining) and 11 (repairs and maintenance).

- 16 By basing the recognition of a provision on the existence of a present obligation, the FRS rules out the recognition of any provision made simply to allocate results over more than one period or otherwise to smooth the results reported. For example, in a regulated industry the results achieved in the current period may cause the pricing structure in the next period to be adjusted, eg the higher the profits in this year the lower the prices permitted for next year. There is no justification under the FRS for a provision to be recognised in such circumstances. The purpose of such a provision would be to transfer some of the current year's profit to the following year, which would suffer from lower prices because of the current year's profits. However, there is no present obligation that requires the transfer of economic benefits to settle it and nothing to justify recognition of a provision.

Probable outflow of economic resources

- 17 An essential part of the definition of a liability is the existence of an obligation to transfer economic benefits. This condition will be met where the transfer of economic benefits is probable, ie more likely than not to occur. Where there are a number of similar obligations the probability of a transfer is determined by considering the class of obligations as a whole.

Reliable estimate of the obligation

- 18 Some respondents to FRED 14 were concerned that the proposals would allow scope for abuse and the avoidance of proper provision because they permitted the non-recognition of a provision where a reliable estimate of the obligation could not be made. In response to these concerns the FRS notes that, except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate that is sufficiently reliable to use in recognising a provision.

Contingent liabilities

- 19 The recognition of contingent losses on the basis of whether they were probable was supported by the respondents to FRED 14. As explained in paragraphs 10 and 11 above, the FRS bases its analysis on contingent liabilities rather than contingent losses and classifies as a provision, rather than a contingent liability, an obligation that is recognised because it will probably require the transfer of economic benefits in settlement. The effect of these requirements of the FRS on the recognition of losses is the same as proposed in FRED 14.

Contingent assets

- 20 The recognition of contingent gains on the basis of whether they were virtually certain was supported by the respondents to FRED 14. As explained in paragraphs 10 and 12 above, the FRS bases its analysis on contingent assets, rather than contingent gains, and requires that a contingent asset should not be recognised. When, however, the realisation of a profit becomes virtually certain, the related asset is not a contingent asset and recognition is appropriate. Accordingly, the effect of the requirements of the FRS on the recognition of gains is the same as proposed in FRED 14.

Measurement

- 21 The FRS requires a provision to be recognised at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The risks and uncertainties that surround events should be taken into account in calculating the amount of the provision. Whatever method of estimation is adopted full disclosure of the uncertainties surrounding the amount of the expenditure is required.
- 22 For a liability where there is a market, the best estimate of that liability at the balance sheet date would be its market value. The FRS recognises that it will often be impossible or prohibitively expensive to settle or transfer an obligation at the balance sheet date because of the uncertainty relating to provisions. By acknowledging this impossibility, the FRS reflects some of the points raised by the respondents to FRED 14. However, a provision should, in principle, be recognised at the amount of the obligation that existed at the balance sheet date—ie the least cost amount to settle the existing present obligation. Even where it is not possible either to settle or transfer the obligation at the balance sheet date, the process of estimating the

amounts at which such hypothetical transactions would take place provides a useful approach to calculating the least cost amount.

- 23 Assuming that it is possible to specify all the possible outcomes and their associated probabilities, the amount to be provided for an obligation could be estimated as:
- *the most likely outcome* (ie the outcome with the highest probability). The problem with calculating the estimate using this method is that it ignores the other possible outcomes: for example, where the most likely outcome is nil it could also lead to the inference that an entity has no obligation.
 - *the maximum amount* (ie the highest possible outcome). Use of this method to calculate the estimate could result in extremely large amounts being recognised even though the possibility of the outcome is remote.
 - *at least the minimum amount in the range* (ie any amount from the lowest possible outcome to the highest possible outcome). This formula results in a wide range of possible estimates and would therefore be likely to impair comparability in financial reporting.
 - *the expected value* (ie the amount that takes account of all possible outcomes using probabilities to weight the outcomes). Expected value as a method of estimation has a number of desirable features. The method provides an estimate that reflects the entire probability distribution, ie all the possible outcomes weighted by their probabilities. For a given assessed distribution, the

method has the advantage of objectivity in that different measurers would calculate the same estimate. Furthermore, expected value is additive (ie the expected value of a number of items is the sum of the expected values of the individual items).

Where there is a large population of items, the expected value—adjusted as appropriate for risk—will provide the best estimate of a provision.

Discounting

- 24 Some provisions that are to be recognised require outflows of economic benefits in settlement far in the future. For some provisions, therefore, the effect of the time value of money—the greater value of a present sum than the certain payment of the same sum some time in the future—can be material and should be taken into account in estimating the amount to be recognised as a provision. Discounting was proposed for provisions in FRED 14 and received the support of the majority of the respondents. The background to the requirements on discounting is set out in the Working Paper ‘Discounting in Financial Reporting’ (published in April 1997). The proposals in the FRS are consistent with that Paper.
- 25 The FRS requires the unwinding of the discount to be included in the profit and loss account as a financial item adjacent to but shown separately from interest. The respondents to FRED 14 were divided over whether the unwinding discount should be shown as interest or as an operating cost. Those who favoured showing it as an operating cost tended to argue that putting this amount in interest would be misleading and confusing to users of accounts and would distort or obscure the view given by the interest and funding

disclosures. The Board has met these concerns by requiring that the unwinding discount should be shown clearly as a separate item from interest. The Board believes that the unwinding discount is a financial item—it relates to the time value of money, reflecting the effect of the passage of time on an amount specified in money terms.

- 26 Provisions that are calculated at a discounted amount should take into account risk as well as the time value of money. Risk can be taken into account either by discounting at a risk-free rate cash flows that take risk into account or by discounting at a risk-adjusted rate cash flows that take no account of risk. The important point is that risk should be taken into account in the best way possible and that care should be taken not to double-count the effect of risk. Among the considerations to be borne in mind are whether it is feasible to derive an appropriate risk-adjusted rate of interest and whether the incidence of risk over the discount period may follow a different pattern from that of compound interest.
- 27 Where the amount recognised is discounted, the cash flows to be discounted are the pre-tax cash flows and the discount rate should be the rate of return that will, after tax has been deducted, give the required post-tax rate of return. Because the tax consequences of different cash flows may be different, the pre-tax rate of return is not always the post-tax rate of return grossed up by the standard rate of tax. The Board requires the effect of tax to be shown separately in financial statements rather than netting tax directly off the assets and liabilities. This is in line with the general requirement that tax effects shall be shown separately.

Expected disposal of assets

- 28 FRED 14 did not refer to the treatment of gains from the expected disposal of assets in measuring provisions. The FRS prohibits such gains from being taken into account in measuring a provision. The principle of the FRS is that provisions should be recognised and measured as liabilities independently of considerations affecting the recognition and measurement of assets held. As a practical matter, if in certain circumstances gains on expected disposals were netted off against the provision to be recognised, it would be difficult to limit the assets whose expected disposal could be set off. There would also need to be guidance on the treatment when the provision was both recognised and used before the gain was achieved.

Reimbursements

- 29 The FRS requires that a provision and any expected reimbursement should be recognised separately as a liability and an asset—although shown net in the profit and loss account. This approach is consistent with the general principle contained in FRS 5 and is designed to reflect the fact that the entity often continues to be liable if the third party from which the reimbursement is due fails to pay. Reimbursement is recognised only when it is virtually certain to be received if the entity settles the liability.

Application of the recognition and measurement rules

- 30 The FRS includes paragraphs applying its recognition and measurement rules to operating losses, onerous contracts and reorganisations. Although the text has changed from FRED 14, the FRS applies the same basic principles as the FRED and has the same effect.

Restructuring provisions

- 31 The most controversial aspect of the proposals in FRED 14 related to the date on which a provision for restructuring should be recognised—the FRED proposed that the date when the entity became demonstrably committed to a reorganisation should be the date a provision was recognised. On this principle, no provision should be recognised if the only relevant event before the balance sheet date was a board decision. The majority of those disagreeing with this proposal argued that it was unrealistically strict and that a provision should be recognised where there was a formal board decision before the year-end and either implementation of that decision began before the signing of the financial statements or the decision was communicated in sufficient detail to those affected by it before that date.
- 32 The Board has discussed the issues raised by the respondents but has concluded that, for the consistent application of its principles, it must require a constructive obligation to restructure to exist at the balance sheet date for a provision for restructuring to be recognised. This is required also for consistency with the treatment of assets: the entity includes in its financial statements only those assets that it controls at the balance sheet date and does not include assets that come under its control only between the balance sheet date and the signing of the financial statements.
- 33 A constructive obligation to restructure arises only when the entity has a detailed formal plan for the reorganisation and, by beginning to implement that plan or communicating it to those affected, raises in them a valid expectation that it will carry out the

restructuring as expected. Therefore a board decision alone (unless one of a supervisory board whose members include employees and possibly other affected interests (see paragraph 82 of the FRS)) does not amount to a constructive obligation to restructure.

Disclosure

- 34 Respondents raised no major concerns with the disclosures proposed by FRED 14.
- 35 The reordering of the FRS to incorporate more fully contingent liabilities and contingent assets has led to the disclosure requirements for these to be set out alongside those for provisions, making clear the consistent basis for the requirements. As part of this rearrangement, the dispensation from providing disclosures that can be expected to prejudice seriously the position of the entity in its negotiations with other parties now applies to contingent liabilities and contingent assets as well as to provisions. The respondents to FRED 14 overwhelmingly supported a ‘seriously prejudicial’ exemption for disclosures on provisions.

Decommissioning costs and repairs and maintenance provisions

- 36 The examples in Appendix III describe two cases where the effect of applying the requirements remains controversial, although the treatment in the examples received general support from the majority of respondents on FRED 14. These are example 3 on decommissioning costs and example 11 on repairs and maintenance.

Decommissioning costs

37 Before the introduction of the FRS, the treatment generally accorded to decommissioning costs was to account for them on the 'units of production' method. Under this method, the amount required for decommissioning is built up year by year, in line with production levels, to reach the amount of the expected decommissioning costs by the time production ceases. The FRS requires that, to the extent that decommissioning costs relate to damage already done or goods and services already received, that present obligation should be recognised as a provision. The following points should be noted when considering the effects of the FRS's requirements on decommissioning costs.

- On installation of the oil rig, the effect of the time value of money is that the true measure of the extra cost of the rig represented by decommissioning costs is the discounted amount of the eventual cost.
- Decommissioning costs will be included in the cost of the oil rig only to the extent that they are incurred by the installation of the rig. If any damage is incurred by production, the costs of restoring that damage is a cost of production—the classic case of this in another industry is open-cast mining where the production process itself increases the damage caused and the consequent cost of restoration.
- The unwinding of the discount reflects the effect of the passage of time and that unwinding is matched in principle by interest or income earned as a result of having a liability that has not yet required the transfer of economic resources in settlement. Setting aside a sinking fund equal to the discounted amount of the liability at any time would provide sufficient cumulative interest

income to settle the decommissioning liability directly without any additional transfer of resources.

- Some respondents have been concerned that the profile over time of the charge arising for decommissioning costs (lower at first but rising over time) could lead to payments of dividends early in the production process in excess of what the business could bear after taking into account its long-term liability for decommissioning costs. However, provided that the assets in the business earn a return in excess of the interest rate used to discount the decommissioning costs, there will be at least sufficient assets to settle the decommissioning costs liabilities when these need to be paid.

Repairs and maintenance

- 38 It is the present practice of some entities to recognise as a provision the future costs of repairing or maintaining part of their fixed assets. Example 11 illustrates the application of the FRS to repairs and maintenance for fixed assets. Because future repairs and maintenance are not present obligations of the entity resulting from past events, no provision should be made for them, even if they are required by legislation if the asset is to continue to be used. There are no grounds for recognising a provision for future repairs and maintenance expenditures because these relate to the future operation of the business, the restoration of service potential, and are therefore either to be capitalised as assets or written off as operating expenses when incurred. Where a part of the asset can be identified as declining in service potential because of the need for repairs or maintenance, it should be depreciated to show the declining service potential. Expenditure on repairs and maintenance should be capitalised to show the restoration of service potential.

- 39 In some operating leases the lessee is required to incur periodic charges for maintenance of the leased asset or to make good dilapidations or other damage occurring during the rental period. The principle illustrated in example 11 does not preclude the recognition of such liabilities once the event giving rise to the obligation under the lease has occurred.

