LKAS 37: Provisions, Contingent Liabilities and Contingent Assets

Introduction

The objective of this Standard 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 enable users to understand their nature, timing and amount.

Provisions

A provision is defined as follows:
‘A provision is a liability of uncertain timing or amount.’

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

- Trade payables are liabilities to pay for goods or services that have been received or supplied.
- Accruals such as amounts due to employees, liabilities to pay for services that have been received or supplied.

In both these situations the uncertainty is generally less than for provisions.

Examples for provisions:

- Provisions for product warranty
- Provision of cleaning up for unlawful environmental damage
- Provision for employee compensation from wrongful dismissals
- Provision for employee bonuses
- Provision for income tax

What is common in these examples is the existence of a present obligation to an external party. In the absence of a present obligation, no provision can be made. As an example, a provision cannot be recognized for repairs and maintenance of machinery because there is no present obligation for repair and maintenance. They are simply future expenses.

a) Recognition of Provisions

A provision should be recognized when:

i. an enterprise **has a present obligation** (legal or constructive) as a result of a past event;
ii. it is **probable that an outflow of resources embodying economic benefits will be required to settle the obligation**; *and*
iii. a **reliable estimate** can be made of the amount of the obligation.

i. The present obligation could be either a **legal obligation** or a **constructive obligation**.
   Legal obligations may arise due to:
   - Operations of contractual law (through its explicit or implicit terms);
   - Operation of provisions in parliament acts; or
   - Operations of other law.

   Examples: Income tax, Warranty obligations etc.

   Constructive obligations may arise due to:
   - Established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; *and*,
   - As a result, a valid expectation created by entity on the part of those other parties will discharge those responsibilities.

     Example: A published policy to pay employee bonuses every year.

ii. **Probable outflow of resources embodying economic benefits**
    An outflow of resources or other event is regarded as probable if the event is more likely to occur than not to occur. In other words, the probability that the event will occur is greater than the probability that it will not. When it is not probable that a present obligation exists, an entity should disclose a contingent liability, if the possibility of an outflow of resources embodying economic benefits or service potential is remote.

iii. **Reliable estimation of the obligation**
    The use of best estimates is an essential part for provisions to be recognized. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and be able to make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision. In extremely rare cases where no reliable estimate can be made, a liability exists that cannot be recognized. In such situations, liability is required to be disclosed as a contingent liability.

b) Measurement of Provision
The amount recognized as a provision should be the **best estimate of the expenditure required to settle the obligation** that existed at the reporting date. Provisions should be reviewed at the end of each reporting date and adjusted to reflect the best estimate. Due

to these reviews, any changes made to provisions should be accounted for as a change in accounting estimate in accordance with LKAS 8 (Prospective Application).

Example: 1

ABC PLC began selling goods with a one-year product warranty from 01.04.20X4. During the year ending 31.03.20X5, the company made sales of Rs. 5,000,000. As of 31.03.20X5, the company has reliably estimated that the cost of repairing products sold under warranty will amount to 5% of the sales made in the year ending 31.03.20X5.

This provision can be recognized as of 31.03.20X5, as all the recognition criteria are met on that date. Therefore, the provision to be recognized as of 31.03.20X5 is:5,000,000 X 5% = 250,000

The journal entry is

Warranty expense Dr 250,000 (Selling and distribution expense)
    Warranty provision Cr 250,000 (Current liability)

Example: 2

In addition to the information provided in Example 1, assume that the financial statements for the year ending 31.03.20X5 were authorized by the company's directors for publication on 15.07.20X5. By this date, the company has estimated that the provision for product warranty for the year ending 31.03.20X5 should be increased by Rs. 100,000. Accordingly, the provision for product warranty as of 31.03.20X5 should be increased by Rs. 100,000, with the additional provision recognized as of 31.03.20X5 as follows:

The journal entry is

Warranty expense Dr 100,000 (Selling and distribution expense)
    Warranty provision Cr 100,000 (Current liability)

Hence, the total provision to be recognized as at 31.03.20X5 is Rs. 350,000.

c) Disclosures Relating to Provisions

For each class of provision, an enterprise should disclose the following:

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 (i.e. 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.

The standard also requires the following disclosures for provisions:

a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events; and
c) The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

Contingent Liabilities

A contingent liability is defined as follows:
A contingent liability is:

a) a **possible obligation** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise;

   (For example, if an employee files a legal case against the company claiming unfair dismissal, and the case is still being heard in court at the reporting date, with professional advice indicating that the outcome is uncertain, it should be treated as a possible obligation at the reporting date.)

   or

b) a **present obligation** that arises from past events but is not recognized because:
   i. it is **not probable** that an outflow of resources embodying economic benefits will be required to settle the obligation;

      (For example, if a guarantee is given to a lender for a loan taken by another entity, and it is uncertain whether the loan will default by the reporting date, the guarantor does not need to recognize a liability.)

      Or

   ii. the amount of the obligation **cannot be measured** with sufficient reliability.

      (For example, if there is a claim for damages against the entity and the entity is defending the claim, but professional advice suggests the defense is unlikely to succeed, and the amount of the claim cannot be reliably measured due to its unique nature, no liability needs to be recognized at the reporting date.)

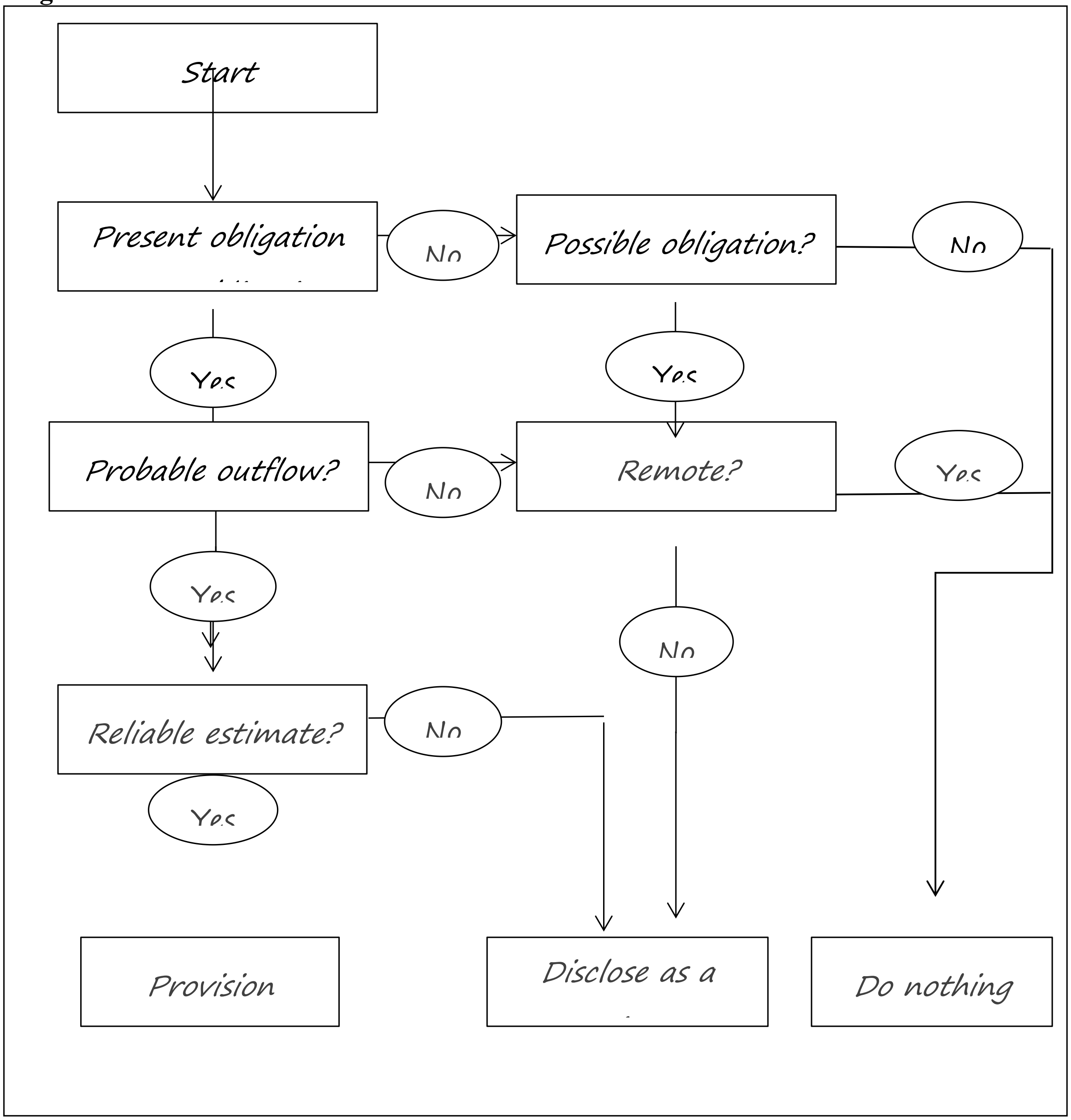
An enterprise should not recognize a contingent liability. However, **a contingent liability should be disclosed** unless the possibility of an outflow of resources embodying economic benefits is remote (far away from certain).

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the Statement of Financial Position, a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect;
(b) an indication of the uncertainties relating to the amount or timing of any outflow; *and*
(c) the possibility of any reimbursement

The distinction between a provision and a contingent liability is summarized and presented in the following Figure: Decision Tree as depicted in LKAS 37.

Figure: Decision Tree



Contingent Assets

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

Contingent assets are not recognized in financial statements. **A contingent asset is disclosed**, where an inflow of economic benefits is probable.

Example: 3

PQR PLC filed a legal case against a competitor for breach of agreement, requesting Rs. 3,000,000 in compensation. PQR PLC's lawyers believe there is a probability of the company winning the case. This constitutes a possible asset for the company and should therefore be treated as a contingent asset. Accordingly, a disclosure should be made in the financial statements.