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LKAS 37 - Provisions, Contingent Liabilities And Contingent Assets

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Learning Objectives

- Explain provisions and liabilities.
- Demonstrate the conditions to be satisfied to recognize a provision in the financial statements.
- Compute provisions to be made in the financial statements.
- Explain contingent liabilities and contingent assets.
- Discuss the factors to be considered in the measurement of provisions.
- Explain the reimbursement, changes in provisions and use of provisions.
- Discuss factors to be considered in recognizing restructuring provisions.
- Outline the disclosures to be made in respect of provisions, contingent liabilities and contingent assets.

Introduction

There are many accounting standards provide guidance for different types of assets, which we learned in the previous lessons. LKAS 37 is the accounting standard that governs the accounting for liabilities. It guides the accounting principles on provisions, contingent liabilities and contingent assets.

Before LKAS 37 was introduced, there was no accounting standard to account for uncertain outcomes in a business. As a result, companies were using the provisions as a method to adjust the profits. If the entity wants to increase profits, provisions were reduced. If the entity wants to reduce the profits, provisions were increased.

There was need to eliminate this use of provisions to manipulate profits and net assets. Thereby, LKAS 37 was introduced. It provides clear definitions, recognition criteria, measurement bases and disclosure requirements for various types of liabilities including provisions.

In certain circumstances the application of LKAS 37 requires management judgement. This standard provides guidance on how to use management judgement by giving various scenarios as well.

Scope

This standard shall be applied for in accounting for provisions, contingent liabilities and contingent assets except for

1. Liabilities in an executory contract (Other than onerous contracts)
   Executory contracts mean, a contract where both parties have performed their obligations to equal extent or both parties have not performed their obligations. The reason is if both parties are at equal performance level, there's no liability to other party. Onerous contracts will be discussed later.
2. Financial liabilities, as it's covered by SLFRS 09 (Financial instruments)
3. Income tax and deferred tax liabilities, as it's covered in LKAS 12 (Income taxes)
4. Lease liabilities, as it's covered by SLFRS 16 (Leases)
5. Employee benefit liabilities, as it's covered by LKAS 19 (Employee benefits)
6. Insurance contract liabilities, as it's covered by SLFRS 04 (Insurance contracts)

7. Contingent consideration liabilities in a business combination, as it's covered by SLFRS 03 (Business combination)
8. Liabilities in a revenue from contracts with customers, as it's covered by SLFRS 15 (Revenue from contracts with customers)
9. Depreciation provisions (LKAS 16, Property plant and equipment standard covers), Amortization provisions (LKAS 38, Intangible assets standard covers) and Impairment provisions (LKAS 36, Impairment standard covers)

This standard is applicable for restricting provisions. If a restructuring falls in to the definition of discontinued operations, additional disclosures may be required as per SLFRS 05 Non-current assets held for sale and discontinued operations standard.

Definitions

Liability

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Summary

- Present obligation
- Past event
- Outflow of resources

Examples

Description	Present Obligation	Past Event	Outflow of Resources	Liability or Not
Bank loan obtained	Company has an obligation to settle the loan	Signing the loan agreement	Paying the loan installments will result in a cash outflow	Yes
Trade creditors	Company has obtained the supplies, therefore, an obligation to settle exists	Obtaining supplied on credit terms	Settling the creditors will result in a cash outflow	Yes
Debentures issued	Company is liable to settle the debentures at maturity. Therefore, an obligation exists	Issuing the debentures	The repayment of debenture at maturity will result in a cash outflow	Yes
Accrued Utility Expenses	Company is liable to settle utility expenses as those were used by the entity	Using the utilities such as water, electricity and telephone	The settlement of accrued expenses will result in a cash outflow	Yes
EPF and ETF Payable	Company is liable to remit the EPF and ETF company and staff share to Central Bank and ETF. Therefore, a present obligation exists.	Recruiting the employees	The remittance of EPF and ETF contributions will result in a cash outflow	Yes

Warranty provision	If a customer claims a warranty, company is liable to settle the claim	Selling products with warranty periods	Settling the warranty claim will result in outflow of cash	Yes

Obligating Event

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

The obligating event means reason why entity has a current obligation. The obligation event shall be a past event. Therefore, entities cannot make provisions for future situations.

As definition stated the past obligating event may arise either due to

- Legal obligation or
- Constructive obligation

Legal Obligation

A legal obligation is an obligation that derives from a

- Contract (through its implicit or explicit terms)
- Legislation or
- Other operation of the law

Examples

- Bank loan is arising from a contract between company and the bank
- Building rent payables are arising from contracts between company and land lords
- Cargills entered in to a contract with a local vegetable provider to purchase minimum quantity. The purchase commitment in the contract is a legal obligation
- EPF contribution payable is arising from parliament act number 02 of 2012 (Amended)
- ETF contribution payable is arising from parliament act number 46 of 1980
- If company breach an environmental law, the penalties payable will be a legal obligation under the parliament act number 53 of 2000
- There are international laws applicable for all countries. For an example International human rights laws, United Nations conventions for law of the sea etc. If a company were to breach such law, the penalty payable will become a legal obligation

Constructive Obligation

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

- By an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities; and
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Examples

- A company has been giving 5% of their annual profits as a bonus to employees. Company has created a separate reserve to pay the bonuses. The bonus payable is a liability arising from a constructive obligation. The company has a past practice and created valid expectation through the reserve that they will pay the bonuses
- A company is selling products with a one-year money back warranty policy. The company has settled the warranty claims in the past as well. The warranty provision is a liability arising from a constructive obligation. The company has a published policy on warranty terms and raised valid expectations to customers through honoring the previous warranty claims
- A company decided to close down a segment. The communications were made to impacted employees, customers and suppliers that company will take the responsibility. The liabilities incurring from closing down shall be recognized as a liability arising from a constructive obligation. The company made a statement, accepted the responsibility and created a valid expectation that company will discharge the responsibility

Note

In some cases, it is not clear whether a past event has given rise to a present obligation. Where this is the case, management must consider whether it is more likely than not that a present obligation as a result of a past event exists. In order to assess this, they must consider all available evidence and, if relevant, the opinion of experts in order to assess whether there is a present obligation as a result of a past event.

For example, in the case of a lawsuit, it may not be clear whether the company has a liability of not. Lawyer's opinion is required to assess the probability of being a present obligation or a possible obligation. If the lawyer concludes that company will become liable, then probability is high, a provision shall have made. If the lawyer is not giving an opinion, it can be treated as a contingent liability. If the lawyer is confident that the company will not be liable, then probability is very low, therefore, there will not be any liability.

Summary

Past obligating event may arise either due to

- Legal obligation

  Legal obligations are obligations arising from

  - Contract
  - Legislation
  - Other operation of a law
- Constructive obligation
  - Accept responsibilities due to
    - Past practice
    - Published policies
    - Statements given
  - & has created a valid expectation on discharge of responsibility

Probable Transfer of Economic Benefits

For the purpose of LKAS 37, a transfer of economic benefits is regarded as 'probable' if the event is more likely than not to occur. This appears to indicate a probability of more than 50%. However, the standard makes it clear that where there is a number of similar obligations, the probability should be based on considering the population as a whole, rather than one single item. For an example the trade payables may include many similar obligations. The probability of transferring the economic benefits is assessed taking entire trade payables in to consideration.

Reliable Estimate

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. LKAS 37 states that in all but 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 recognizing a provision.

In very rare cases where a reliable estimate cannot be made, the liability which is not recognized must be disclosed as a contingent liability (refer the contingent liability topic).

For an example, the company for the first time issued warranties. Company is unaware of how to measure the warranty claims due to non-availability of past data or experience. Company is not in a position to use any other method. Therefore, the warranty claims were not recognized but considered as a contingent liability.

Provisions

A provision is a liability of uncertain timing or amount.

Summary

- A liability of uncertain
- Timing or
- Amount

LKAS 37 distinguishes provisions from other liabilities such as trade payable and accruals. This is on the basis that for a provision, there is uncertainty about the timing or amount of the future payment.

Examples

- A company is providing 06 months' warranty for products sold.
- Warranty provision, Utility bills provision, Income tax provision

Onerous Contracts

An onerous contract is a contract in which the unavoidable costs of fulfilling the terms of the contract exceed the benefit to be gained from the contract.

If an entity has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision.

Summary

Unavoidable cost of meeting obligation	>	Economic benefits expected to receive

E.g. Darshan signed a 10year non-cancellable lease agreement with an annual rental of Rs.100, 000/-. Two years later, rupasinghe decided to vacate the property and relocate the business due to a change in strategic direction. The non-cancellable lease agreements remaining 08 years unavoidable cost is higher than the economic benefits expected to receive from the vacated property. Therefore, it's an onerous contract.

Accounting Treatment for onerous contract

The present obligation under the contract shall be recognized in full as an expense

E.g. Darshan shall recognize the entire present obligation of Rs.800, 000/- (100, 000*08) as a provision.

Dr Provision expense 800, 000

Cr Contract payable 800, 000

Contingent Liability

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 entity's control, or

A present obligation that arises from past events but is not recognized because:

- It is not probable that a transfer of economic benefits will be required to settle the obligation, or
- The amount of the obligation cannot be measured with sufficient

Summary

- Possible obligation
- Resulted from Past events
- Existence will be confirmed
- by uncertain future event not within control

E.g. Court case Filed against company claiming damages, Bank guarantees provided, A warranty provision of which the value cannot be estimated reliably.

Restructuring program

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

Summary

- Program
- Planned & controlled by management
- Which will Materially change
- Scope of business
- way business managed

A restructuring may include:

(a) The sale or termination of a line of business

(b) The closure of business locations in a geographical area or the relocation of business activities from one area to another

(c) Changes in management structure

(d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.

In the case of a restructuring, a provision for associated costs may only be made when there is a constructive obligation. This is the case when an entity:

- Has a detailed formal plan for the restructuring
- Has raised a valid expectation in those affected by it that it will carry out the restructuring (either by starting to implement the plan or by announcing its main features to affected parties)

In the case of the sale of an operation, there is no obligation until there is a binding sale agreement.

Recognition – General

General recognition criteria

- Probable outflow of future economic Resources
- Cost can be measured reliably

Recognition, Measurement and Disclosures Summary

Description	Recognition	Measurement	Disclosures
Provision	If it meets following 03 criteria • Present obligation as a result of a past event • Probable outflow of future economic Resources • Cost can be measured reliably Yes recognized	Best estimate of expense required to settle liability • Methods used • Expected value • Experts reports • Similar transaction value • Events after reporting date Please refer detail explanation below	• Carrying amount • Additional provision • Used provision • Reversed provision
Contingent Liability	Not recognized as it does not meet the recognition criteria	Reliable estimate on fair value of probable outflow	• Description of the nature • Financial estimate if any
Contingent Asset	Not recognized as it does not meet the recognition criteria Not recognized	Reliable estimate on fair value of probable inflow	Only if the inflow of future economic benefits is probable discloses

			• Description of the nature
Restructuring program	If general recognition criteria met, recognized	Include • Direct expenditure Exclude • Expense on current operations • relocating existing staff • Marketing • Investment in new system	• Description of the nature • Amount
Onerous Contract	If general recognition criteria met, recognized	The total remaining liability will be expensed	N/A

Measurement of Provisions

The amount recognized as a provision should be the best estimate of the expenditure required settle the present obligation at the end of the reporting period.

Single obligation

Where a provision relates to just one item, all possible outcomes should be considered. The best estimate of the expenditure will normally be the most likely outcome, however:

- If all other possible outcomes are mostly higher, the best estimate will be a higher amount.
- If all other possible outcomes are mostly lower, the best estimate will be a lower amount.

Large population of items

When a provision is needed that involves a lot of items, then the provision is calculated using the expected value approach. The expected value approach takes each possible outcomes and weights it according to the probability of that outcome happening.

Discounting

Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditure required to settle the obligation. An appropriate discount rate should be used.

The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Future events

Future events that are reasonably expected to occur (e.g. new legislation and changes in technology) may affect the amount required to settle the entity's obligation and should be taken into account when measuring a provision.

Gains from the expected disposal of assets should not be taken into account in measuring a provisions.

Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party. If so, the reimbursement should be recognized 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, and the amount recognized should not be greater than the provision itself.
- The provision and the amount recognized for reimbursement may be netted off in profit or loss.

Changes in provisions

Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of resources will be required to settle the obligation, the provision should be reversed.

Use of provisions

A provision should be used only for expenditures for which the provision was originally recognized. Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

Scenarios

As the application of LKAS 37 require a degree or judgement in its application, the standard provides details of the correct treatment to be applied in a number of situations.

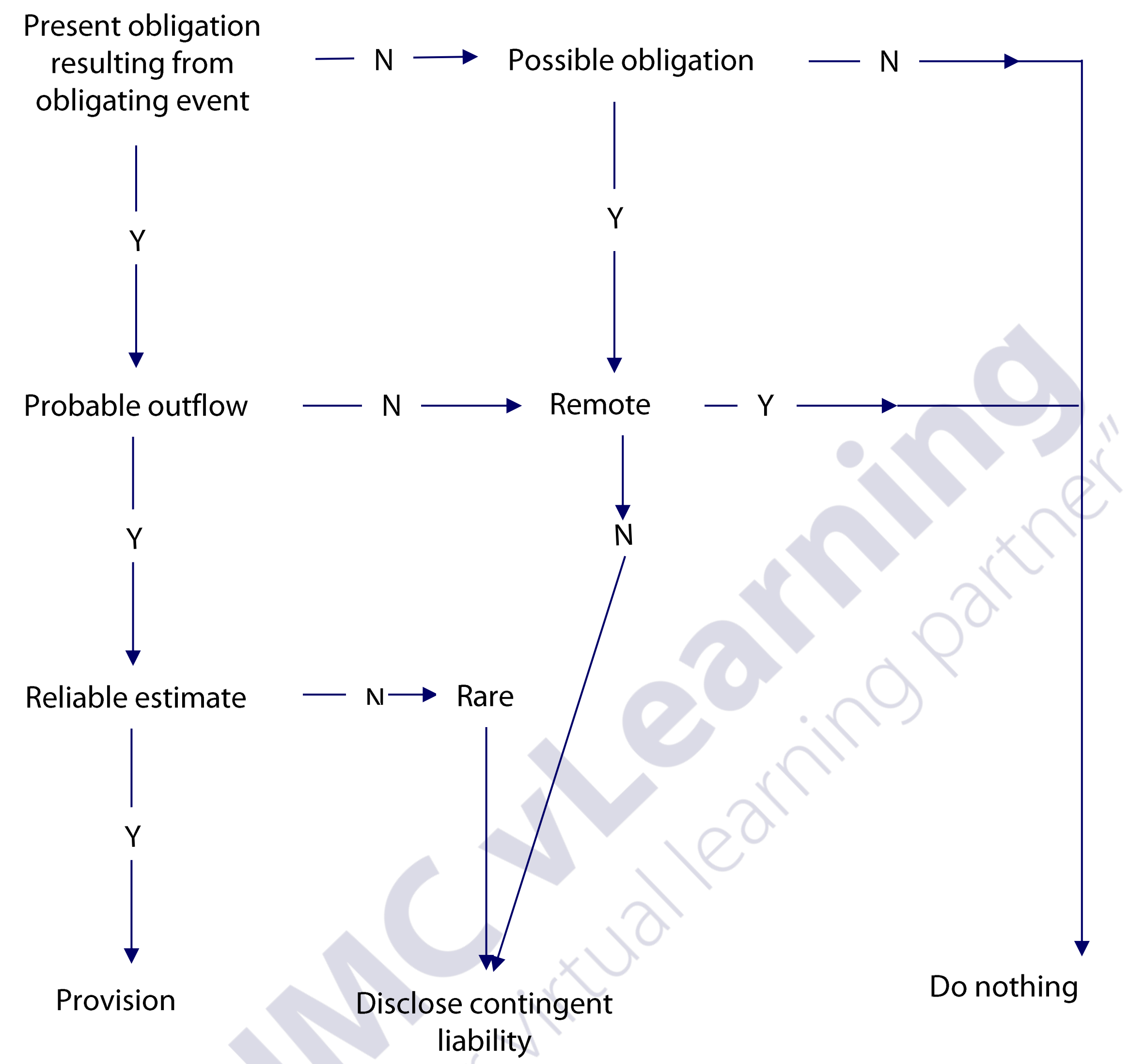
Future operating losses

Provisions should not be recognized for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard.

Other Considerations

- If Management or Board decision is not communicated it may not create constructive obligation
- If a new law is substantially enacted, required provisions if any have to be recognized

Decision Tree for Provisions and Contingent Liabilities



Decision Tree for Contingent Assets