Deliberation on IFRS

IAS-1,2,,7, 8,10, 12,16,17,18,19,20, 23, 24,27,28,31,32,36,37,38,39,40

IFRS -5,6,7, 8

by

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International
Accounting Standards
Board®

IAS-37

Provisions, Contingent Liabilities and Contingent Assets

Scope

Accounting for –

- Provisions
- Contingent liabilities
- Contingent assets

Scope

Exclusion –

- Those resulting from executory contracts, except where the contract is onerous; and
- Those covered by another Standard

Definitions

Provisions is a liability -

- A present obligation (legal or constrictive) as a result of past event
- Outflow of resources involved to settle the obligation
- Reliable estimate an be made of that obligation except in rare cases

Definitions

Liability -

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

Definitions

Obligating event –

- Create a legal or constructive obligation
- Results in an entity having no realistic alternative but to settle it.

Legal obligation-

- Derive from law (e.g. contract, statute, courts etc)

Definitions

Constructive liability -

Established through pattern of past practice, published policies, a specific current statement and valid expectations created that it will be settled.

Definitions

Contingent liability

- A possible obligation from past events whose existence will be confirmed only on the occurrence or non-occurrence of one or more uncertain future events that are not wholly within the control of the entity; or
- a present obligation from past events that is not recognised because -

Definitions

Contingent liability

- a present obligation from past events that is not recognised because –

  - an outflow of economic benefits is not probable; or

  - the obligation cannot be measured with sufficient reliability

Definitions

Contingent assets

- A possible asset, that arises from past events, whose existence will be confirmed only on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity

Definitions

Onerous Contract

- The unavoidable costs of the contract exceed the benefits to be obtained

Recognition issues

- Warranties
- Contamination
- Refunds
- Future legal requirement
- Staff retraining
- Refurbishment costs

Measurement

- The amount provided should be the best estimate at the end of the reporting period of the expenditure requires to settle the obligation
- Often expressed as the amount -

  - which could be spent to settle the obligation immediately; or

  - To pay to third party to assume it

Measurement

- May use -

  - Expected values

  - Most likely outcome

  - present value

Measurement example

A warranty covers costs of repairing manufacturing defects discovered within 12 months of purchase. Repair costs for all products are estimated at –

$ 100,000 for minor defects

$ 400,000 for major defects

Past experience indicate that of goods sold

75% will have no defects

20% will have minor defects

5% will have major defects

Change in provisions

- Provisions should be reviewed regularly and if the estimate of the obligation has changes, the amount recognised as a provision should be revised accordingly.
- Provision may be used ONLY for the expenditures that relate to the matter for which they were originally recognised.

Provision Accounting

An entity becomes subject to an obligating event on 1st Jan 09.As a result, it is committed to expenditure of $10m in 10 years time. An appropriate discount factor is 8%

Initial measurement $\$10m \times 1/(1+0.08)^{10} = 4.632$

Profit or loss	Dr.	4.632	
To Provision			4.632

Provision Accounting

Re-measurement $10m x $1/(1+0.08)^9 = 5.003$

Financial position notes extract	$m
Balance brought forward	4.632
Borrowing costs (8% x 4.632)	0.371
Carried forward	5.003

Profit or loss	Dr.	0.371	
To Provision			0.371

Provision Accounting

Re-measurement $10m x $1/(1+0.08)^8$ = 5.403

Financial position notes extract	$m
Balance brought forward	5.003
Borrowing costs (8% x 5.003)	0.400
Carried forward	5.403

Profit or loss	Dr.	0.400	
To Provision			0.400

Decommission costs

- Costs of removing/restoring a production facility
- A provision should be recognised as soon a an obligating event occurs
- This may be at the start of the contract
- The debit may be the cost of the asset (IAS 16 specifically allows for)

Environmental damage example

X has an obligation to restore environmental damage. Restoration will be carried out as follows-

Phase (1) to remove the contaminated soil will cost \$2m in the year to 30th June2009

Phase (2) replanting the area is estimated to cost \$3.5m three years later

Pre-tax cost of capital is 10%

Expenditure, when incurred, will attract tax relief at 30%

Calculate the provision at 30th June 2008

Contingent liabilities and assets

- Do not recognise
- disclose contingent liabilities (as outflow of economic benefit is only ‘possible’)
- ignore contingent liabilities if remote
- Recognise contingent assets if virtually certain
- Disclose contingent assets if probable

Future operating losses

- No provision should be made
  - the losses do not arise out of a past event
  - they are not unavoidable
- However, the expectation of future losses may indicate the need for an impairment loss to be recognised

Reimbursements

Where some or all of the expenditure required to settle a provision expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will b received if the entity settles the obligation. The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall not exceed the amount of the provision.

Restructuring -definition

- 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 on which that business is conducted

Restructuring -example

Example include -

- Sale or termination of a line of business
- Closure of business locations in a region
- Relocation from one region to another
- Changes in management structure
- Fundamental re-organization

Restructuring -provision

- A provision should only be recognised when a constructive obligation to restructure has occurred
- A number of conditions mist be met
- The provision should include only those expenditures that are both –

  - Necessarily entailed by the restructuring

  - Not associated with the on going activities

Restructuring -conditions

- Detailed formal plan for the restructuring (minimum requirements specified)
- A valid expectations has been raised by:

  - starting to implement the plan;

  - announcing its main features to those effected by it
- There is no obligation for the sale of an operation until there is a blinding sale agreement

Restructuring costs

- Redundancy cost
- Costs of retraining/relocating continuing staff
- Contract termination costs
- Marketing
- Investment in new distribution networks
- Future operating losses up to the date of restructuring
- Gains on expected disposal of assets
- Sundry expenditures incurred in the reorganization

Disclosure

For each class of provision-

- Carrying amount at the beginning
- Additional provision made, increase to the existing provision
- Amount used
- Unused amount reversed
- Increase during the period in discounted amount due to passage of time

Disclosure

For each class of provision, the entity shall disclose brief description of the nature obligation and the expected timing, indication of the uncertainties about the amount.

For each class of contingent liability a brief description and nature and, where practicable, estimate of its financial effect and indicating the uncertainties and the possibility of any reimbursement

THANK

YOU

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