

# IAS – 37 Provisions , Contingent Liabilities & Contingent Assets

PROVISION



CA Kevin Daftary  
Sr.GM - Welspun

**WELSPUN**



Dare to Commit

# Agenda

When you have completed this session, you will be able to:

- Comparison with Indian GAAP
- Identify the scope of IAS 37
- Define provisions according to IAS 37
- Define Contingent liability according to IAS 37
- Define constructive obligation according to IAS 37
- Explain when provisions are recognised
- Describe how provisions are measured under IAS 37
- Explain how IAS 37 treats reimbursements and offsetting gains
- Explain how IAS 37 treats future operating losses and onerous contracts
- Explain the disclosure requirements for provisions

## Comparison with Indian GAAP

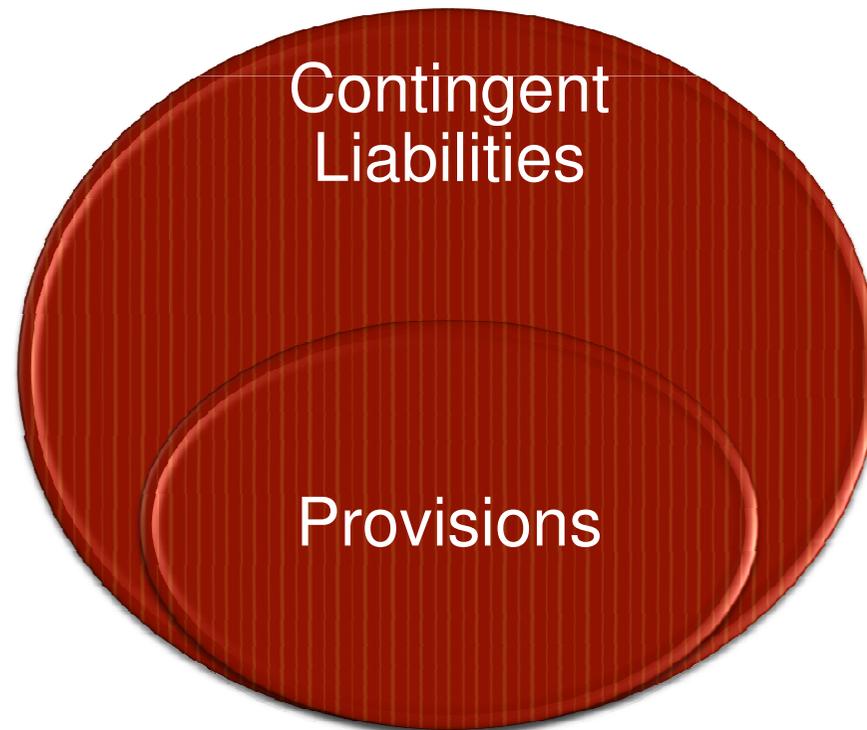
<b>Area</b>	<b>Indian GAAP</b>	<b>IFRS</b>
Discounting	Prohibited	Required
Contingent asset	Disclosure not permitted in the financial statements. However, the same can be disclosed in the director's report.	Disclosure required
Decommissioning liability	Not dealt with directly	IFRIC 1
Constructive obligation	Not dealt with	Dealt with in IFRS as can be seen in next slides

## Scope

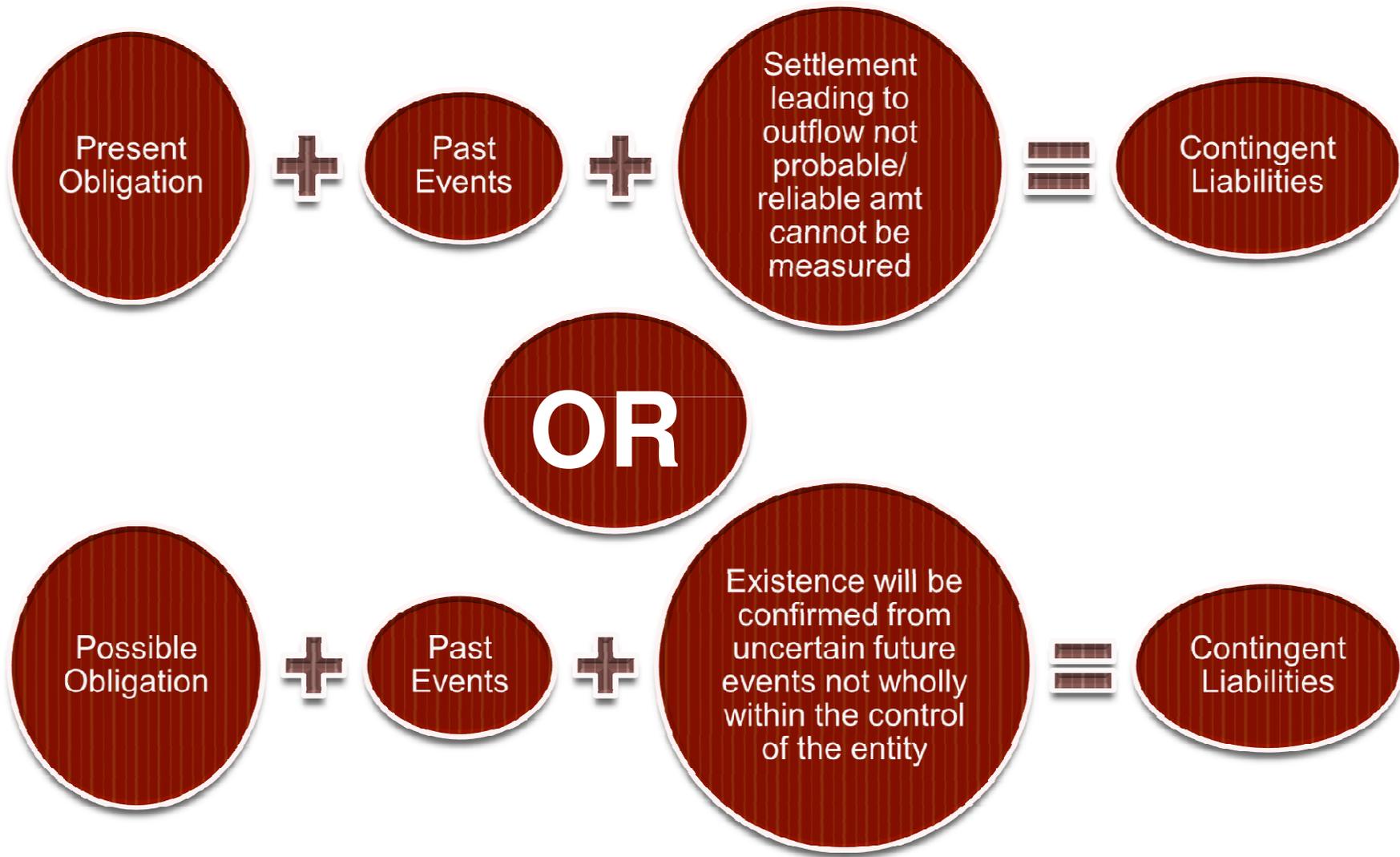
This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:

- those resulting from executory contracts, except where the contract is onerous; and
- those covered by another Standard.
  - IAS 11 Construction Contracts
  - IAS 12 Income taxes
  - IAS 17 Leases except onerous operating leases
  - IAS 19 Employee Benefits
  - IFRS 4 Insurance contracts
- those resulting from financial instruments that are carried at fair value.

# Conceptual Framework



# Conceptual Framework

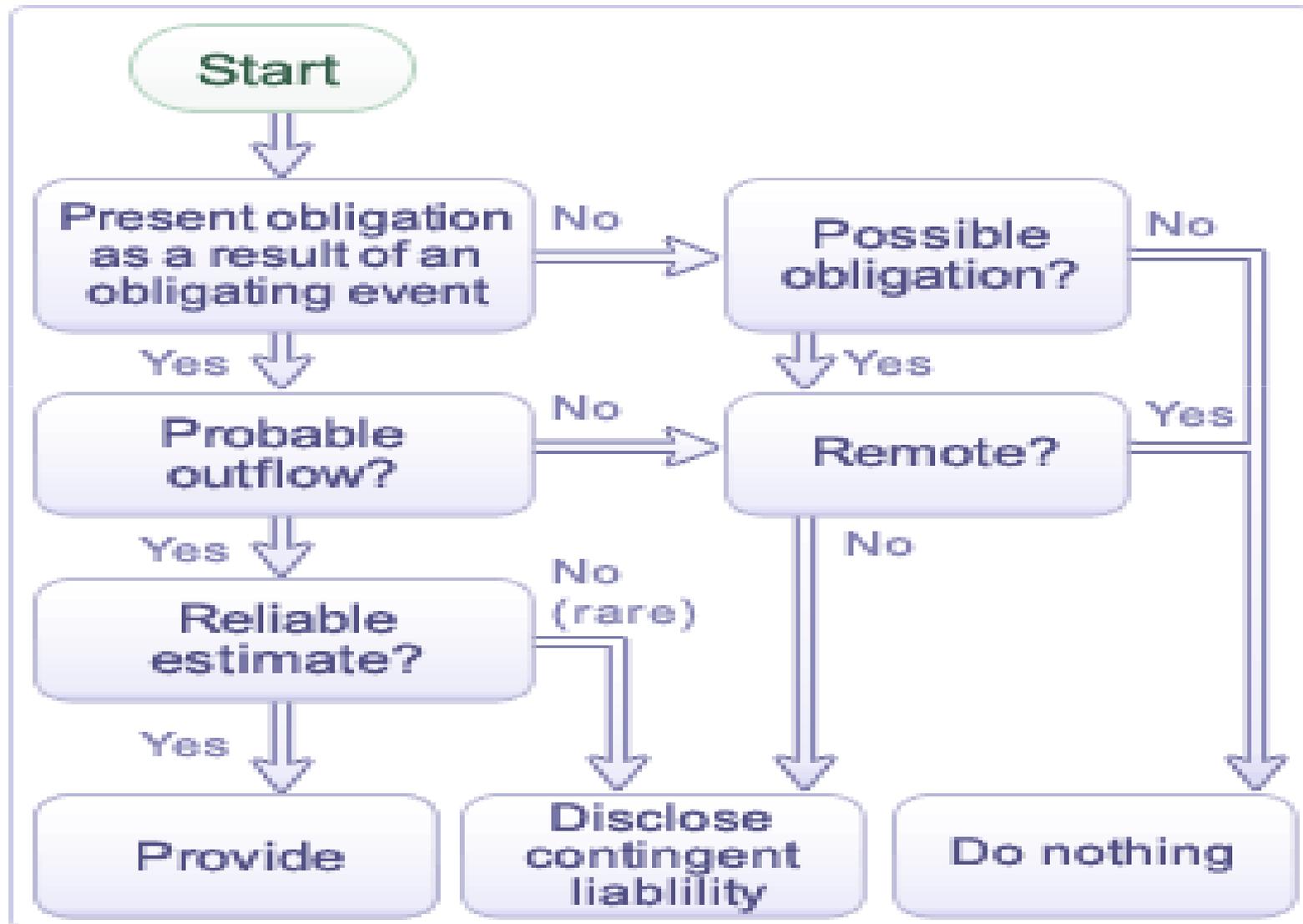


# Conceptual Framework

- 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.
  
- A **constructive obligation** is 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.

E.g. 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 the **record of honouring** this published policy.

# Conceptual Framework



# Recognition

- A provision shall 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 an outflow of resources embodying 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 shall be recognised.**
  
- In rare cases e.g. in a lawsuit , 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 end of the reporting period.

# Recognition

## **Practical Insight – Air France KLM Inc.**

- In February 2006, the European Commission charged Air France-KLM and 27 other airlines with price fixing air shipping services. Subsequently, more than 40 purported class-action lawsuits seeking compensatory damages for prices paid since January 2000 were filed against air cargo operators. At the time, Air France-KLM reported that it was “unable to predict the outcome of these investigations requested by antitrust and civil litigation authorities, or the amount of penalties and compensatory damages which could be due.” Therefore, because of the lack of information, Air France-KLM simply disclosed the case in its 2006 financial statements without recording a provision for a loss.
- The following year, when more civil suits were filed, the outcome remained difficult to predict. Air France-KLM disclosed the information and attempted to calm investors by stating that it did “intend to defend these cases vigorously.”

# Recognition

## **Practical Insight – Air France KLM Inc.**

- By 2008, however, it became apparent to Air France-KLM that a loss was likely to occur and that the amount of the loss was reasonably estimable. Therefore, the company reported a provision but (as permitted under IAS 37) did not disclose a dollar amount, stating, “the amount of the provision allocated...is not given, as such information is likely to harm the companies in their defense towards the competition authorities.”
- Finally, in 2009 the fines were charged and paid, and Air France-KLM not only disclosed details of the case but also recorded a provision for the liability. The provision recorded in the books as of March 2010 “represents the best estimation of the risk...”

# Recognition

## **Contingent Assets & Contingent Liabilities**

- **An entity shall not recognise a contingent asset or a contingent liability.**
- They may develop in a way not initially expected. Hence they need to be assessed continually to ensure that developments are appropriately reflected in financial statements.
- A provision is recognised in the financial statements of the period in which the change in probability (outflow of the resources becomes probable) occurs except in the extremely rare circumstances where no reliable estimate can be made.

## Measurements

- The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- 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 risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

# Measurements

## **Example 3 Provision for warranty claims**

- 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 an outflow for the warranty obligations as a whole.
- The expected value of the cost of repairs is:  $(75\% \text{ of nil}) + (20\% \text{ of } 1\text{m}) + (5\% \text{ of } 4\text{m}) = 400,000$

## Measurements

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

# Measurements

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be 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.
- In the statement of comprehensive income, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

## Measurements

- In case if the entity remains liable for the failure of third party to discharge its payment obligations then provision shall be recognised for the full amount of liability. If the liability of the entity is solely restricted to its obligations then entity being not liable for the said costs would not be required to be provided for.
- 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.
- Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.
- A provision shall be used only for expenditures for which the provision was originally recognised.
- Provisions shall not be recognised for future operating losses.

# Measurements

## Example 1 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 relate to the removal of the oil rig and restoration of damage caused by building it, and 10 per cent arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but **no oil has been extracted**.

## Example 2 Legal requirements to fit smoke filters

- Under **new legislation**, an entity is **required to fit smoke filters** to its factories by 30 June 2001. The **entity has not fitted the smoke filters**.
  - i) At 31 December 2000, disclosure / recognition of provision required in the financial statements ?
  - ii) At 31 December 2001, disclosure / recognition of provision required in the financial statements ?

## Onerous Contracts

- An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
- For onerous contract, the provision is recognised and measured at the lower of:
  - a) The cost of fulfilling the contract
  - b) The costs/penalties incurred in cancelling the contract.
- 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.

### **Example : An onerous contract**

- An entity operates profitably from a factory that it has **leased** under an operating lease. During December 20X0 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**.

# Restructuring

- 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.

# Restructuring

- No obligation arises for the sale of an operation until the entity is committed to the sale, i.e. there is a binding sale agreement.
- A restructuring provision shall 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 on-going activities of the entity.
- A restructuring provision does not include following costs as they relate to the future conduct of business and are not liabilities for restructuring at the end of the reporting period.
  - (a) retraining or relocating continuing staff;
  - (b) marketing; or
  - (c) investment in new systems and distribution networks.

# Restructuring

## Example 1 Closure of a division

- On 12 December 20X0, the board of an entity decided to close down a division making a particular product. On 20 December 20X0 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.

## Disclosure

- For each class of provision, an entity shall 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 (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.
  
- Comparative information is not required.
  
- An entity shall 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 outflows of economic benefits;contd.

## Disclosure

- An entity shall disclose the following for each class of provision:  
(contd):
  - (b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall 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 recognised for that expected reimbursement.
  
- Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting period 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.

## Disclosure

- Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect.
- Where any of the information required by standard is not disclosed because it is not practicable to do so, that fact shall be stated.
- In extremely rare cases, disclosure of some or all of the information required by standard can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

# IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

- Changes in the measurement arises due to a change in:
  - Estimated timing of payments.
  - Estimated amount of payments embodying economic benefits
  - Discount rate
- Adjusted depreciable amount to be prospectively depreciated over remaining useful life. However, if the asset has reached its useful life, all subsequent changes in liability to be recognized in statement of profit & loss.
- Applies regardless of accounting policy (cost or revaluation model) but implementation varies.

# IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

## ➤ Cost model:

- Changes in liability amount shall be added/deducted from cost of the related asset in current period.
- Deduction from cost of asset should not exceed its carrying amount and any excess of liability over carrying amount of assets should be recognised immediately in statement of profit or loss.
- Consideration of impairment needs to be checked for increase in carrying amount.

# IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

## ➤ Revaluation Model

**Decrease in liability**

- **Revaluation surplus (except reversal of previous revaluation deficit)**

**Increase in liability**

- **Profit or loss (except credit balance remaining in revaluation surplus)**

# Thank You

**For any information/clarification please contact:**

CA Kevin Daftary  
SGM- Welspun Enterprises  
Kevin\_daftary@welspun.com  
98200 93682

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Assisted by:  
CA Debasish Paul  
Tirthesh Shah  
Hiren Gada  
Debasish\_paul@welspun.com