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LKAS 37 – Provisions, Contingent Liabilities & Contingent Assets

AAT Level II

FCA - Financial & Costing Accounting

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<u>LKAS 37 – Provisions, Contingent Liabilities & Contingent Assets</u>

<u>Provisions</u>

Liabilities are obligations arising from a past event that will lead to an outflow of economic resources. Most liabilities can be measured accurately. For example, if you take out a bank loan then you know exactly how much you have to repay, and when the repayments are due. Provisions, however, involve more uncertainty.

A provision is a liability of uncertain timing or amount.

A Provision should only be recognized when all of three conditions are met:

01. An entity has a present obligation (legal or constructive) as a result of a past event.
02. It is probable an outflow of resources embodying economic benefits will be required to settle the obligation
03. A reliable estimate can be made of the amount of the obligation.

Ex:

01. Court case claims
02. Warranty Provisions

<u>Question 01</u>

TechZone Ltd sells 1,000 smartphones in December. As a business practice company give a **one-year warranty** for each phone sell. Based on past experience, the company expects that **5% of the phones** will require repairs costing **Rs. 2,000 per phone**.

Whether this can be recognized as a Provision?

<u>Contingent Liabilities</u>

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

- A present obligation that arises from past events but does not meet the criteria for recognition as a provision. This is either because an outflow of economic benefits is not probable or (more rarely) because it is not possible to make a reliable estimate of the obligation.
- A contingent liability **should not be recognised**. However, it **should be disclosed** unless the possibility of a future outflow of economic benefits is remote.

- Contingent liabilities should be reviewed regularly. If an outflow of economic benefits becomes probable, then they must be reclassified as provisions.

Ex:

Entity G is involved in a legal dispute with a customer, who is making a claim against Entity G for losses it has suffered as a consequence of a breach of contract. Entity G's solicitors believe that the likelihood of the claim succeeding is possible rather than probable, and they estimate the possibility at about 30% to 40%.

Contingent Assets

- A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the outcome of one or more uncertain future events, not wholly within the control of the entity.
- A contingent asset should not be recognized.
- A contingent asset should be disclosed if the future inflow of economic benefits is probable.
- If the future inflow of benefits is virtually certain, then it ceases to be a contingent asset and should be recognized as a normal asset.

Ex:
A company files a lawsuit against another company, claiming **Rs. 10 million** in damages.
The company believes it has a strong case and **might** win the lawsuit—but the court has **not** given the final ruling yet.