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LKAS 37 - Provisions, Contingent Liabilities And Contingent Assets

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1.0 Objective

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.

2.0 Definitions

a. A provision is a liability of uncertain timing or amount
b. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (As per 2019 Bound Volume of SLFRS)
   "A liability is a present obligation of the entity to transfer an economic resource as a result of past events." (Latest CFW)
c. 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.
d. A legal obligation is an obligation that derives from:
   (a) a contract (through its explicit or implicit terms);
   (b) legislation; or
   (c) other operation of law.
e. 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.
f. 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 entity
g. 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
h. 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.

3.0 Examples of Provision and it will be different from Liabilities

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4.0 Recognition of Provision

A provision shall be recognized 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.

5.0 Measurement of Provision

a. Best estimate, the amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability and for more complex situation we can use probabilities.

Example 01.01 – Single obligation - Most Likely

During the year an employee was dismissed under unfair grounds, therefore he has brought a legal proceeding against the company. As per the lawyers, the employee has a chance of 80% in succeeding the case and the damages were amounted to 10 MN
Discuss how it will be accounted for?

Examples 01.02 – Expected Value

Hopewell sells a line of goods under a six-month warranty. Any defect arising during that period is repaired free of charge. Hopewell has calculated that if all the goods sold in the last six months of the year required repairs the cost would be $2 million. If all of these goods had more serious faults and had to be replaced the cost would be $6 million.
The normal pattern is that 80% of goods sold will be fault-free, 15% will require repairs and 5% will have to be replaced.
What is the amount of the provision required?

b. Present value - 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.

Example 02 – Present Value

Rey Co constructed an oil platform in the sea on 1 January 20X8 at a cost of $150m. As part of obtaining permission to construct the platform, Rey Co has a legal obligation to remove the asset at the end of its useful life, which is 5 years. This obligation has a value of $32.21m.
Calculate the provision and discuss how it will be accounted for?

Example 03 - Overhaul

Candel has acquired a machine which require an overhaul in next 3 years' time, the cost of overhaul will be $5,000. What is the amount of the provision required?

Example 04 – Environmental provision

Rey Co has a published environmental policy. In this, Rey Co explains that they always carryout necessary steps to counter-balance the environmental damage created by their operations. Rey Co has a consistent history of honoring this policy. During 20X8, Rey Co opened a new factory, leading to some environmental damage. Rey Co estimate that the damage will cost $400,000 to restore.
Discuss how it will be accounted for ?

Example 05 Reimbursement

Rey Co's legal advisors continue to believe that it is likely that Rey Co will lose the court case against the employee and have to pay out $10m. However, it has come to light that Rey Co may have a counter claim against the manufacturer of the machinery and the agreed reimbursement will be $8m.
Discuss how it will be accounted for ?

i. Changes in 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.
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j. Use of provisions - A provision shall be used only for expenditures for which the provision was originally recognised.

k. Future operating losses Provisions shall not be recognised for future operating losses.

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6.0 Contingent Liability

A contingent liability is:

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

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

An entity shall not recognize a contingent liability, rather disclose the details

Question 06

Silva PLC Supplies cut fruits to MI-HI Hotel, during the year she heard that the Hotel customers have suffered attacked of food-poisoning. The hotel has claimed that this is because of Silva's cut fruits, and has commenced a legal action against the Company.

Heshan, a local lawyer who specializes in food-poisoning cases, had advice Silva at there is a change of 42% of losing the case and the amount will be 5 Mn.

Discuss how it will be reflected int SILVA PLCs FS?

6.0 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 nonoccurrence of one or more uncertain future events not wholly within the control of the entity.

An entity shall not recognize a contingent asset, rater disclose the details

Question 07 (Refer Example 05)

Rey Co's legal advisors continue to believe that it is likely that Rey Co will lose the court case against the employee and have to pay out $10m. However, it has come to light that Rey Co may have a counter claim against the manufacturer of the machinery. The legal advisors believe that there is an 80% chance that the counter claim against the manufacturer is likely to succeed, and believe that Rey Co would win $8m.

Discuss how it will be accounted for?

I. Decision Rule – Diagram

Criteria	Contingent Liabilities	Contingent Assets
Virtually Certain	Provide	Provide
Probable	Provide	Disclose
Possible	Disclose	Nothing
Remote	Nothing	Nothing

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 (ie 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.