

Provisions and Contingencies

1. What are the criteria for provisions and contingencies being recognized?
 - a) The entity has an obligation at the reporting date as a result of a past event.
 - b) The entity has a receivable at the reporting date as a result of a past event.
 - c) It is probable (i.e. more likely than not) that the entity will be required to transfer economic benefits in settlement.
 - d) It is probable (i.e. more likely than not) that the entity will be receive a transfer of economic benefits in settlement.
 - e) The amount of the obligation can be estimated approximately.
 - f) The amount of the obligation can be estimated reliably.

2. A provision should be measured at:
 - a) cost.
 - b) fair value.
 - c) best estimate of the amount required to settle the obligation at the reporting date.

3. Decide which statements are true:
 - a) When the provision involves a large population of items, the estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities.
 - b) When the provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation.
 - c) At subsequent measurement an entity can charge against a provision any expenditures it needs.

4. An entity:
 - a) shall recognize contingent assets and liabilities.
 - b) shall not recognize contingent assets and liabilities.
 - c) shall not recognize contingent assets, but shall recognize contingent liabilities.
 - d) shall recognize contingent assets, but shall not recognize contingent liabilities.

5. Decide if in the following cases corresponding provisions can be recognized?
 - a) Waste from an entity's production process contaminated the groundwater at the entity's plant. In a lawsuit brought against the entity, members of the local community seek compensation for damages to their health as a result of the contamination. The entity acknowledges its wrongdoing and the court is deciding on the extent of the compensation to be awarded to the members of the local community. It is uncertain when the ruling will take place but the entity's lawyers expect it will take place in about two years and they estimate that the compensation awarded by the court will be in the range CU1 million–CU30 million.

- b) Waste from an entity's production process contaminated the groundwater at the entity's plant. In this example there is no court case. However, the entity is required by law to restore the contaminated environment. The entity estimates that such restoration will cost between CU1 million and CU15 million. The entity is unsure of the date by which it will be required to complete the restoration.
- c) A manufacturer gives warranties to the purchasers of its goods. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale to the purchasers. On 31 January 20X1 a manufacturing defect was detected in the goods manufactured by the entity between 1 December 20X0 and 31 January 20X1. At 31 December 20X0 (the entity's reporting date) the entity held about one week's sales in inventories. The entity's financial statements for the year ended 31 December 20X0 have not yet been finalised.
- d) An entity that operates ten petrol stations and owns the land and buildings for those stations chooses not to purchase fire insurance on those buildings but, rather, to 'self insure' in case of fire loss. The entity can estimate reliably the statistical probability of the occurrence and amount of expected fire loss (loss of about CU100,000 once every ten years). The entity wants to recognise a provision of CU10,000 and related expense each year for the next ten years to reflect its expected loss. The entity argues that the loss is highly probable, the amount can be measured reliably, and if it had purchased insurance it would recognise an expense in each reporting period.
- e) A ski resort operator operates in a cyclical business, with 'good years' and 'bad years' depending primarily on the weather. The entity believes that, because of the earnings volatility, it is prudent to defer recognition of a portion of the profit in a 'good year' to the inevitable 'bad year' by recognising a provision in 'good years' and reversing the provision in 'bad years'. The owners of the entity are in full agreement with recognising a provision in the good year. Also, the local income tax law allows deferral of a portion of the profit in a 'good year' to help ensure that ski resort operators have cash to continue operating in 'bad years'. The amount of the entity's accrual under the IFRS for SMEs is based on the tax law.
- f) An entity operates an open-cast mine in a jurisdiction where environmental rehabilitation laws state that all mine shafts deeper than 10 metres must be entirely filled in by 31 December 2X20 or the mining company that dug the holes for the shafts will be required to pay a substantial fine. The geologists' reports indicate that the entity will be able to extract significant quantities of ore for at least 20 years. The ore is located 15 metres below the surface.
- i. At 31 December 20X0 the entity has not started mining.
 - ii. At 31 December 20X1 the entity has sunk a shaft 5 metres deep. It is highly likely that the entity will mine beyond 10 metres in the future and therefore will be obliged to fill in each shaft.
 - iii. At 31 December 20X2 the entity has sunk a shaft 12 metres deep.

- g) An entity has made a written pledge to contribute a substantial sum of money toward the construction of a new performing arts centre in its community. Executives of the entity appeared in a press conference to announce the pledge. With the entity's consent, the charitable organisation that is building the arts centre has cited the entity's pledge in its materials soliciting additional pledges for construction. Under local law, pledges to charitable organisations are not legally enforceable.
- h) Waste from an entity's production process contaminated the groundwater at the entity's plant. The entity is not required by law to restore the contaminated environment and there is no court case. However, before the end of the current reporting period the entity made a public announcement that it would restore the contaminated environment within the next 12 months.

Example 1: Initial measurement of provisions

An entity's production process causes contamination to the land on which the entity's plant is built. The entity is required by law to restore the environment at the end of its plant's useful life. The estimated lifetime of the plant is 5 years. The entity envisages costs for site restoration varying from CU200,000 with 55% of probability and to CU275,000 with 45% probability. Adjustment for uncertainties is 5% and appropriate discount factor for risk-adjusted cash flows is 10%.

What is the recognized amount of the provision, if any, in this case?

Example 2: Initial measurement of provisions

An entity sells 1,000 units of a product with warranties under which the entity will repair any manufacturing defects that become apparent within the first six months after purchase. If a minor defect is detected in a product, estimated repair costs of CU100 will result. If a major defect is detected in a product, estimated repair costs of CU400 will result. The entity's experience together with its future expectations indicate that 75 per cent of the goods sold have no defects, 20 per cent of the goods sold have minor defects and 5 per cent of the goods sold have major defects.

For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.

What is the recognized amount of the provision, if any, in this case?

Example 3: Initial measurement of provisions

A customer has initiated a lawsuit against an entity associated with personal injury when using one of the entity's products. The entity's lawyers estimate from experience that at the reporting date (31 December 20X1) the entity has:

- a) a 30 per cent chance of being ordered to pay the customer compensation of CU2 million and a 70 per cent chance of being ordered to pay compensation of CU 300,000. The ruling is

expected to take place in two years' time. The entity determines that a discount rate of 4 per cent is appropriate to adjust for the risks specific to the liability.

- b) a 25 per cent chance of being ordered to pay the customer compensation of CU100,000, a 50 per cent chance of being ordered to pay compensation of CU300,000 and a 25 per cent chance of being ordered to pay compensation of CU500,000. For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.
- c) a 75 per cent chance of winning the lawsuit and thereby avoiding the payment of compensation. Furthermore, the entity's lawyers estimate that the entity has a 10 per cent chance of being ordered to pay the customer compensation of CU2 million and a 15 per cent chance of being ordered to pay compensation of CU300,000. For the purpose of this example, the risks specific to the liability and the time value of money have been ignored.

What is the recognized amount of provision, if any, in every of these cases?

Example 4: Expenditures charged against a provision

An entity recognized a CU40,000 provision for a lawsuit at 31 December 20X1. In March 20X2 the case was dismissed without the right to appeal. In April 20X2 the entity undertook an advertising campaign costing CU40,000. The entity made the following entry in its accounting records to recognize the advertising campaign:

Db: Provision for lawsuit (liability) = CU40,000

Cr: Cash = CU40,000

Is such accounting (journal entry) correct?

Correct entries:

Db Provision (BS)

Cr P/L

Db P/L

Cr Cash