Accounting (Basics) - Lecture 6

Provisions and contingencies

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Initial recognition

- **An entity shall recognize a provision** only when:
  a) the entity has **an obligation** at the reporting date as **a result of a past event;**
  b) **it is probable** (i.e. more likely than not) that the entity will be required to transfer economic benefits in settlement; and
  c) **the amount of the obligation can be estimated reliably**.
- **The entity shall recognize the provision as a liability in the statement of financial position and shall recognize the amount of the provision as an expense**, unless another section of these IFRS requires the cost to be recognized as part of the cost of an asset such as inventories or property, plant and equipment.

Initial recognition

- The condition of obligation at the reporting date as a result of a past event means that the **entity has no realistic alternative to settling the obligation.** This can happen when the entity has a legal obligation that can be enforced by law or when the entity has a constructive obligation because the past event (which may be an action of the entity) has created valid expectations in other parties that the entity will discharge the obligation. **Obligations that will arise from the entity's future actions** (i.e. the future conduct of its business) **do not satisfy such condition, no matter how likely they are to occur and even if they are contractual**. To illustrate, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a particular type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation or selling the factory, it has no present obligation for that future expenditure and no provision is recognized.

Initial and subsequent measurement

- **An entity shall measure a provision at the best estimate of the amount required to settle the obligation** at the reporting date. The best estimate is the amount an entity would rationally **pay to settle the obligation** at the end of the reporting period or **to transfer it** to a third party at that time.
- 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**. Where **there is a continuous range of possible outcomes**, and each point in that range is as likely as any other, the **mid-point of the range is used**.
- 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.
- When the **effect of the time value of money is material, the amount of a provision shall be the present value of the amount expected to be required to settle the obligation.**

Initial and subsequent measurement

The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money. The risks specific to the liability should be reflected either in the discount rate or in the estimation of the amounts required to settle the obligation, but not both.

- **An entity shall exclude gains from the expected disposal of assets from the measurement of a provision.**
- When some or all of the **amount required to settle a provision may be reimbursed by another party**, **the entity shall recognize the reimbursement as a separate asset only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation. The amount recognized for the reimbursement shall not exceed the amount of the provision**. The **reimbursement receivable shall be presented in the statement of financial position as an asset and shall not be offset against the provision**.

Initial and subsequent measurement

In the statement of comprehensive income, the entity may offset any reimbursement from another party against the expense relating to the provision.

- **At subsequent measurement an entity shall charge against a provision only those expenditures for which the provision was originally recognized**. An entity shall **review provisions at each reporting date** and adjust them to reflect the current best estimate of the amount that would be required to settle the obligation at that reporting date. **Any adjustments to the amounts previously recognized shall be recognized in profit or loss** unless the provision was originally recognized as part of the cost of an asset. **When a provision is measured at the present value** of the amount expected to be required to settle the obligation, the **unwinding of the discount shall be recognized as a finance cost in profit or loss in the period it arises.**

Contingent assets and liabilities

- **An entity shall not recognize a contingent asset as an asset.** Disclosure of a contingent asset is required when an inflow of economic benefits is probable. **However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.**
- **A contingent liability is either a possible but uncertain obligation or a present obligation that is not recognized because it fails to meet one or both initial recognition criteria** (b) and (c) stated earlier. **An entity shall not recognize a contingent liability as a liability, except for provisions for contingent liabilities of an acquire in a business combination**. Disclosure of a contingent liability is required unless the possibility of an outflow of resources is remote. When an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

Disclosures

- For each class of **provision**, an entity shall disclose:
  a) **a reconciliation** showing:
     i. the carrying amount at the beginning and end of the period;
     ii. additions during the period, including adjustments that result from changes in measuring the discounted amount;
     iii. amounts charged against the provision during the period; and
     iv. unused amounts reversed during the period.
  b) a brief description of the **nature of the obligation** and **the expected amount and timing of any resulting payments**.
  c) **an indication of the uncertainties** about the amount or timing of those outflows.
  d) the **amount of any expected reimbursement**, stating the amount of any asset that has been recognized for that expected reimbursement.
- Comparative information for prior periods is not required.

Disclosures

- Unless the possibility of any outflow of resources in settlement is remote, an entity shall disclose, for each class of **contingent liability** at the reporting date, a brief description of the nature of the contingent liability and, when 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.**
- If an inflow of economic benefits is probable, but not virtually certain, an entity shall disclose a description of **the nature** of **the contingent assets** at the end of the reporting period, and, when practicable without undue cost or effort, an estimate of their **financial effect. If it is impracticable to make this disclosure, that fact shall be stated.**