IAS 37 — Provisions, Contingent Liabilities and Contingent Assets

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Overview

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* outlines the accounting for provisions (liabilities of uncertain timing or amount), together with contingent assets (possible assets) and contingent liabilities (possible obligations and present obligations that are not probable or not reliably measurable). Provisions are measured at the best estimate (including risks and uncertainties) of the expenditure required to settle the present obligation, and reflects the present value of expenditures required to settle the obligation where the time value of money is material.

IAS 37 was issued in September 1998 and is operative for periods beginning on or after 1 July 1999.

History of IAS 37

Date	Development	Comments
August 1997	Exposure Draft E59 *Provisions, Contingent Liabilities and Contingent Assets* published	
September 1998	IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* issued	Operative for annual financial statements covering periods beginning on or after 1 July 1999
30 June 2005	Exposure Draft *Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent*	Comment deadline 28 October 2005 (proposals were not finalised, instead being

	Assets and IAS 19 Employee Benefits published	reconsidered as a longer term research project)

Related Interpretations

- IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*
- IFRIC 5 *Rights to Interests Arising from Decommissioning, Restoration and Environmental Funds*
- IFRIC 6 *Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*
- IFRIC 17 *Distributions of Non-cash Assets to Owners*
- IFRIC 21 *Levies*

Amendments under consideration by the IASB

- Research project — Non-financial liabilities
- Research project — Discount rates

Summary of IAS 37

Objective

The objective of IAS 37 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 the financial statements to enable users to understand their nature, timing and amount. The key principle established by the Standard is that a provision should be recognised only when there is a liability i.e. a present obligation resulting from past events. The Standard thus aims to ensure that only genuine obligations are dealt with in the financial statements – planned future expenditure, even where authorised by the board of directors or equivalent governing body, is excluded from recognition.

Scope

IAS 37 excludes obligations and contingencies arising from: [IAS 37.1-6]

- financial instruments that are in the scope of IAS 39 *Financial Instruments: Recognition and Measurement* (or IFRS 9 *Financial Instruments*)
- non-onerous executory contracts
- insurance contracts (see IFRS 4 *Insurance Contracts*), but IAS 37 does apply to other provisions, contingent liabilities and contingent assets of an insurer
- items covered by another IFRS. For example, IAS 11 *Construction Contracts* applies to obligations arising under such contracts; IAS 12 *Income Taxes* applies to obligations for current or deferred income taxes; IAS 17 *Leases* applies to lease obligations; and IAS 19 *Employee Benefits* applies to pension and other employee benefit obligations.

Key definitions [IAS 37.10]

Provision: a liability of uncertain timing or amount.

Liability:

- present obligation as a result of past events
- settlement is expected to result in an outflow of resources (payment)

Contingent liability:

- a possible obligation depending on whether some uncertain future event occurs, or
- a present obligation but payment is not probable or the amount cannot be measured reliably

Contingent asset:

- 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.

Recognition of a provision

An entity must recognise a provision if, and only if: [IAS 37.14]

- a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event),
- payment is probable ('more likely than not'), and
- the amount can be estimated reliably.

An obligating event is an event that creates a legal or constructive obligation and, therefore, results in an entity having no realistic alternative but to settle the obligation. [IAS 37.10]

A constructive obligation arises if past practice creates a valid expectation on the part of a third party, for example, a retail store that has a long-standing policy of allowing customers to return merchandise within, say, a 30-day period. [IAS 37.10]

A possible obligation (a contingent liability) is disclosed but not accrued. However, disclosure is not required if payment is remote. [IAS 37.86]

In rare cases, for example in a lawsuit, it may not be clear whether an entity has a present obligation. In those 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 balance sheet date. A provision should be recognised for that present obligation if the other recognition criteria described above are met. If it is more likely than not that no present obligation exists, the entity should disclose a contingent liability, unless the possibility of an outflow of resources is remote. [IAS 37.15]

Measurement of provisions

The amount recognised as a provision should be the best estimate of the

expenditure required to settle the present obligation at the balance sheet date, that is, the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party. [IAS 37.36] This means:

- Provisions for one-off events (restructuring, environmental clean-up, settlement of a lawsuit) are measured at the most likely amount. [IAS 37.40]
- Provisions for large populations of events (warranties, customer refunds) are measured at a probability-weighted expected value. [IAS 37.39]
- Both measurements are at discounted present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the liability. [IAS 37.45 and 37.47]

In reaching its best estimate, the entity should take into account the risks and uncertainties that surround the underlying events. [IAS 37.42]

If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised as a separate asset, and not as a reduction of the required provision, when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The amount recognised should not exceed the amount of the provision. [IAS 37.53]

In measuring a provision consider future events as follows:

- forecast reasonable changes in applying existing technology [IAS 37.49]
- ignore possible gains on sale of assets [IAS 37.51]
- consider changes in legislation only if virtually certain to be enacted [IAS 37.50]

Remeasurement of provisions [IAS 37.59]

- Review and adjust provisions at each balance sheet date
- If an outflow no longer probable, provision is reversed.

Some examples of provisions

Circumstance	Recognise a provision?
Restructuring by sale of an operation	Only when the entity is committed to a sale, i.e. there is a binding sale agreement [IAS 37.78]
Restructuring by closure or reorganisation	Only when a detailed form plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A Board decision is insufficient [IAS 37.72, Appendix C, Examples 5A & 5B]
Warranty	When an obligating event occurs (sale of product with a warranty and probable warranty claims will be made) [Appendix C, Example 1]
Land	A provision is recognised as contamination occurs for

contamination	any legal obligations of clean up, or for constructive obligations if the company's published policy is to clean up even if there is no legal requirement to do so (past event is the contamination and public expectation created by the company's policy) [Appendix C, Examples 2B]
Customer refunds	Recognise a provision if the entity's established policy is to give refunds (past event is the sale of the product together with the customer's expectation, at time of purchase, that a refund would be available) [Appendix C, Example 4]
Offshore oil rig must be removed and sea bed restored	Recognise a provision for removal costs arising from the construction of the the oil rig as it is constructed, and add to the cost of the asset. Obligations arising from the production of oil are recognised as the production occurs [Appendix C, Example 3]
Abandoned leasehold, four years to run, no re-letting possible	A provision is recognised for the unavoidable lease payments [Appendix C, Example 8]
CPA firm must staff training for recent changes in tax law	No provision is recognised (there is no obligation to provide the training, recognise a liability if and when the retraining occurs) [Appendix C, Example 7]
Major overhaul or repairs	No provision is recognised (no obligation) [Appendix C, Example 11]
Onerous (loss-making) contract	Recognise a provision [IAS 37.66]
Future operating losses	No provision is recognised (no liability) [IAS 37.63]

Restructurings

A restructuring is: [IAS 37.70]

- sale or termination of a line of business
- closure of business locations
- changes in management structure
-

fundamental reorganisations.

Restructuring provisions should be recognised as follows: [IAS 37.72]

- **Sale of operation:** recognise a provision only after a binding sale agreement [IAS 37.78]
- **Closure or reorganisation:** recognise a provision only after a detailed formal plan is adopted and has started being implemented, or announced to those affected. A board decision of itself is insufficient.
- **Future operating losses:** provisions are not recognised for future operating losses, even in a restructuring
- **Restructuring provision on acquisition:** recognise a provision only if there is an obligation at acquisition date [IFRS 3.11]

Restructuring provisions should include only direct expenditures necessarily entailed by the restructuring, not costs that associated with the ongoing activities of the entity. [IAS 37.80]

What is the debit entry?

When a provision (liability) is recognised, the debit entry for a provision is not always an expense. Sometimes the provision may form part of the cost of the asset. Examples: included in the cost of inventories, or an obligation for environmental cleanup when a new mine is opened or an offshore oil rig is installed. [IAS 37.8]

Use of provisions

Provisions should only be used for the purpose for which they were originally recognised. They should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources will be required to settle the obligation, the provision should be reversed. [IAS 37.61]

Contingent liabilities

Since there is common ground as regards liabilities that are uncertain, IAS 37 also deals with contingencies. It requires that entities should not recognise contingent liabilities – but should disclose them, unless the possibility of an outflow of economic resources is remote. [IAS 37.86]

Contingent assets

Contingent assets should not be recognised – but should be disclosed where an inflow of economic benefits is probable. When the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. [IAS 37.31-35]

Disclosures

Reconciliation for each class of provision: [IAS 37.84]

- opening balance
-

additions

- used (amounts charged against the provision)
- unused amounts reversed
- unwinding of the discount, or changes in discount rate
- closing balance

A prior year reconciliation is not required. [IAS 37.84]

For each class of provision, a brief description of: [IAS 37.85]

- nature
- timing
- uncertainties
- assumptions
- reimbursement, if any.

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