Accounting Standard Study Group

CIMA Sri Lanka division

SLAS 36: Provisions, Contingent Liabilities and Contingent Assets

Objective

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.

Scope

- This standard should be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except those resulting from executor contracts unless the contract is onerous.
- This standard does not apply to financial instruments (including guarantees) covered under the financial instruments standard.
- This standard applies to provisions, contingent liabilities and contingent assets of insurer other than those arising from contracts with policyholders.
- This standard applies to provisions for restructuring (including discontinuing operations).
- This standard does not apply to contracts which neither party have performed any of its obligations or both parties have partially performed obligations.
- Where a another Sri Lankan accounting standard (SLAS) deals with a specific type of provision, contingent liability or contingent asset the relevant standard is given preference over SLAS 36.
- Provisions relating to recognition of revenue are not addressed by the standard.
- Depreciation, impairment of assets and doubtful debts are not addressed in this standard.

Key definitions

A provision is a liability of uncertain timing or amount.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of economic benefits.

An obligating event is an event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation.

A legal obligation is an obligation that derives from:

- a contract (through its explicit or implicit terms)
- legislation or
- other operation of law.

A constructive obligation is an obligation that derives from an entity's actions where: 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 as a result, the entity has created a valid expectation on the part of those other parties that it will perform those responsibilities.

A contingent liability:
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.

A present obligation that arises from past events but is not recognised because:

- it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or
- the amount of the obligation cannot be measured with sufficient reliability.

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 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.

A restructuring is a programme that is planned and controlled by management, and materially changes either:

- the scope of a business undertaken by an entity ,or
- the manner in which that business is conducted.

Relationship between provisions and contingent liabilities:
Within the standard provisions are recognised as liabilities as they are present obligations where a reliable estimate can be made and an economic outflow is required to settle obligations. Contingent liabilities however are liabilities which are not recognised as their existence will be confirmed only by an occurrence or non occurrence of one or more uncertain future events.

Recognition
Provisions: A provision should be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
- a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

- Present obligation: The entity should determine at the balance sheet date by taking into account all available evidence (opinion of experts etc)whether it is more likely than not that an obligation exists.

- Obligating event: A past event that leads to a present obligation is called an obligating event. ‘It is necessary that there is no realistic alternative to settling the obligation created by the event, i.e. - settling the obligation being enforced by the law.’

- Probable outflow of resources embodying economic benefits: A liability to qualify for recognition there must be a probable outflow of resources embodying economic benefits. In the case of a number of similar obligations the whole class of obligations is considered in determining the probable outflow required in the settlement.

- Reliable estimate of the obligation: Provisions by nature are more uncertain than most other balance sheet items except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. Moreover in extremely rare case where no reliable estimate can be made, and the liability exists that cannot be recognised. Then that liability is disclosed as a contingent liability

Contingent liabilities

An entity should not recognise a contingent liability*.* A contingent liability is disclosed if the possibility of an outflow of resources embodying economic benefits is remote.

Where an enterprise 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.

Contingent liabilities developed to continuously assess and determine the probable.Outflow of resources embodying economic benefits. In case of probable outflow of future economic benefits then it will be recognise in the financial statements of the period in which the change of the probability occurs.

Contingent Assets: An entity should not recognise contingent asset. These are not recognised in the financial statements as this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is no more a contingent asset and its recognition becomes appropriate.
Where an inflow of economic benefits is probable then the contingent asset is disclosed.

Contingent assets are continuously assessed to the developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an enterprise discloses the contingent asset.

Measurement

- Best estimates: 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. The entity should weight all possible outcomes by their associated probabilities if the provision being measured involves a large population of items. Where a single obligation is being measured the individual most likely outcome is used.

- Risks and uncertainties: The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision. A prudent approach is to be used when projected costs are calculated.

- Present value: Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation. Provisions are discounted, where the effect is material.

- Future events: Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

- Expected disposal of assets: Gains from the expected disposal of assets should not be taken into account in measuring a provision. Instead, an entity recognises gains on expected disposals of assets at the time specified by the Sri Lanka Accounting standard dealing with the assets concerned.

Reimbursements: Where some or all of the expenditure required settling a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

Changes in provision

Provisions 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 embodying economic benefits will be required to settle the obligation, the provision should be reversed.
Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as a borrowing cost.

Use of provisions: A provision should be used only for expenditures for which the provision was originally recognised.

Application of the recognition and measurement rules

- Future operating losses: Provisions should not be recognised for future operating losses. Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity tests these assets for impairment under -SLAS 41 impairment of assets.
- Onerous contracts: the present obligation under this contract should be recognised and measured as a provision.

Restructuring

Examples of events that may fall under the definition of restructuring:

- Sale or termination of a line of business.
- The closure of business locations in a country or region or the relocation of business activities from one country or region to another.
- Changes in management structure, for example, eliminating a layer of management.
- Fundamental reorganisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met.

A constructive obligation to restructure arises only when an entity, has a detailed formal plan for the restructuring identifying at least:

- The business or part of a business concerned.
- The principal locations affected.
- The location, function, and approximate number of employees who will be compensated for terminating their services.
- The expenditures that will be undertaken.
- When the plan will be implemented, and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Restructuring decisions made before the balance sheet date does not give rise to a constructive obligation at the balance sheet date. Unless the enterprise has, before the balance sheet date:

- started to implement the restructuring plan, or
- announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the enterprise will carry out the restructuring.

No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e. there is a binding sale agreement**.**

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

- necessarily entailed by the restructuring, and
- not associated with the ongoing activities of the entity.

A restructuring provision does not include such costs as:

- retraining or relocating continuing staff
- marketing, or
- investment in new systems and distribution networks.

Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract (as defined).

Disclosure: For each class of provision, an enterprise should disclose:

- The carrying amount at the beginning and end of the period.
- Additional provisions made in the period, including increases to existing provisions.
- Amounts used (i.e. incurred and charged) against the provision during the period.
- Unused amounts reversed during the period, and
- 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.

An entity should disclose the following for each class of provision:

- A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.
- An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events.
- The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

- An estimate of its financial effect.
- An indication of the uncertainties relating to the amount or timing of any outflow,and
- The possibility of any reimbursement.

Where an inflow of economic benefits is probable, an enterprise should disclose a brief description of the nature of the contingent assets at the balance sheet date and where practicable an estimate of their financial effect measured using the principles set out for provisions in paragraphs.

An example for provisions and contingent liabilities-

After a wedding in 2000, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year to 31 December 2000, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year to 31 December 2001,its lawyers advice that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 December 2000

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion - No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 December 2001

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation. An outflow of resources embodying economic benefits in settlement - probable.

Conclusion - a provision is recognised for the best estimate of the amount to settle the obligation.

Source- (IFRS 37- Provisions, contingent liabilities and contingent assets)

Disclaimer

This document is compiled with the objective of presenting a basic overview of the respective Sri Lanka Accounting Standard, and does not construe professional advise in application of the Standard. For specific application and understanding of all facets of the Standard, the relevant Sri Lanka Accounting Standard issued by The Institute of Chartered Accountants of Sri Lanka should be referred.

Useful web-links pertaining to Accounting Standards

http://www.icasrilanka.com/Technical/Accounting%20Standards.html

http://www.iasb.org/Home.htm

Compiled by the members of the Accounting Standard Study Group

Manil Jayasinghe (Chairman)

Achintha Gamage

Chamil Hathurusinghe

Jayani Amarasinghe

Kanagasabapathy Arulmoly

Methmal Seneviratne

Nilushika Gunasekera

Dharshan Cooray