

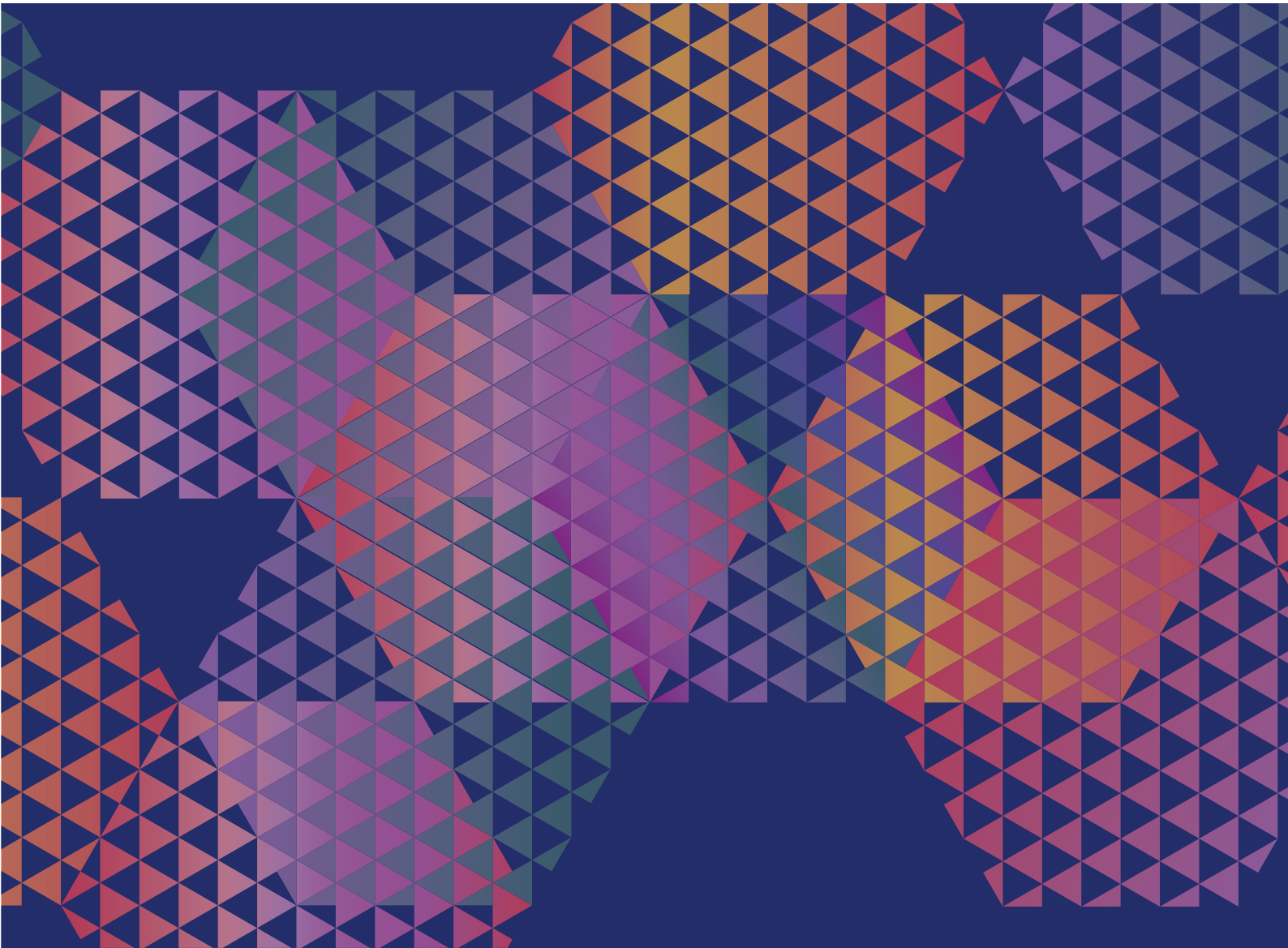


IFRS[®]
Accounting

Educational Module 21
Provisions and Contingencies

IFRS for SMEs[®]

Accounting Standard
Third Edition



International Accounting Standards Board

IFRS[®] Foundation
Supporting Material for the
IFRS for SMEs[®] Accounting Standard

including the full text of
Section 21 *Provisions and Contingencies* of the
IFRS for SMEs Accounting Standard issued by
the International Accounting Standards Board in February 2025

with extensive explanations, self-assessment questions and case studies

This document is not part of the *IFRS for SMEs* Accounting Standard or IFRS Accounting Standards and does not add to or otherwise change the requirements in the Standards. It was developed to aid stakeholders' understanding of our Standards. Views expressed in the document do not necessarily reflect those of the International Accounting Standards Board or the IFRS Foundation. The document should not be relied upon as professional or investment advice.

Copyright © 2026 IFRS Foundation

All rights reserved. Reproduction and use rights are strictly limited. No part of this publication may be translated, reprinted, reproduced or used in any form either in whole or in part or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage and retrieval system, without prior permission in writing from the IFRS Foundation.

The IFRS Foundation has trade marks registered around the world including 'FSA[®]', the 'Hexagon Device' logo[®], 'IAS[®]', 'IASB[®]', 'IFRIC[®]', 'IFRS[®]', the 'IFRS[®] logo', 'IFRS for SMEs[®]', 'ISSB[®]', 'International Accounting Standards[®]', 'International Financial Reporting Standards[®]', 'International Financial Reporting Standards Foundation[®]', 'IFRS Foundation[®]', 'NIIF[®]', 'SASB[®]', 'SIC[®]', 'SICS[®]', and 'Sustainable Industry Classification System[®]'. Further details of the IFRS Foundation's trade marks are available from the IFRS Foundation on request.

The IFRS Foundation is a not-for-profit corporation under the General Corporation Law of the State of Delaware, USA and operates in England and Wales as an overseas company (Company number: FC023235) with its principal office in London.

Contents	<i>from page</i>
INTRODUCTION	5
<i>IFRS for SMEs Accounting Standard</i>	5
What does this module cover?	5
Which version of the Standard does this module refer to?	6
Introduction to the requirements	6
What has changed in the third edition of the Standard?	6
REQUIREMENTS AND EXAMPLES	7
Scope of this section	7
Initial recognition	10
Initial measurement	19
Subsequent measurement	25
Contingent liabilities	30
Contingent assets	34
Disclosures	36
Appendix to Section 21	42
SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS	47
TRANSITION REQUIREMENTS	48
COMPARISON WITH FULL IFRS ACCOUNTING STANDARDS	49
TEST YOUR KNOWLEDGE	50
APPLY YOUR KNOWLEDGE	56
Case study 1	56
Answer to Case study 1	58
Case study 2	60
Answer to Case study 2	61

The requirements of Section 21 *Provisions and Contingencies* of the *IFRS for SMEs Accounting Standard* are set out in this module and shown with grey shading. Appendix B of the *IFRS for SMEs Accounting Standard* (Glossary) is also part of the requirements. Terms defined in the Glossary are reproduced in **bold type** the first time they appear in the text of Section 21.

This module has been prepared by International Accounting Standards Board (IASB) technical staff. The educational notes and examples inserted by the staff are not shaded. These educational notes and examples do not form part of the *IFRS for SMEs Accounting Standard* and have not been approved by the IASB.

INTRODUCTION

***IFRS for SMEs*[®] Accounting Standard**

The *IFRS for SMEs Accounting Standard* (Standard) is intended for use by entities that publish general purpose financial statements and that do not have public accountability (referred to as small and medium-sized entities—see Section 1 *Small and Medium-sized Entities* of the Standard).

The objective of general purpose financial statements is to provide financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

More information about the Standard and its supporting materials is available on the IFRS Foundation website: www.ifrs.org.

What does this module cover?

This educational module supports the requirements for accounting for and reporting of provisions and contingencies in accordance with Section 21 *Provisions and Contingencies* of the Standard. This module:

- provides explanatory notes and examples designed to improve understanding of the requirements in Section 21;
- identifies the significant judgements required in accounting for provisions, contingent liabilities and contingent assets;
- includes questions designed to test your understanding of the requirements in Section 21; and
- includes case studies that provide a practical opportunity to apply the Section 21 requirements.

After completing the module, you should be able:

- to distinguish provisions from an entity's other liabilities and determine which provisions should be accounted for in accordance with Section 21;
- to identify the cases in which provisions should be recognised in financial statements;
- to measure provisions on and subsequent to initial recognition;
- to present and disclose provisions in financial statements including additional consideration for prejudicial disclosures;
- to identify, estimate the financial effect of, and disclose contingent liabilities and contingent assets in financial statements; and
- to demonstrate an understanding of the significant judgements required in accounting for and reporting provisions, contingent liabilities and contingent assets.

Which version of the Standard does this module refer to?

Any reference in this module to 'the *IFRS for SMEs* Accounting Standard' is to the third edition of the Standard, issued February 2025.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity that is useful to existing and potential investors, lenders and other creditors when making decisions relating to providing resources to the entity.

The objective of Section 21 is to prescribe the requirements for recognising and measuring provisions, contingent liabilities and contingent assets, and disclosures to enable users to understand their nature, timing and amount.

What has changed in the third edition of the Standard?

The IASB changed Section 21 in the third edition of the Standard by:

- clarifying the definition of 'liability' used in the section;
- removing requirements relating to contingent consideration in a business combination from the scope as a consequence of the revised Section 19 *Business Combinations and Goodwill*;
- including within the scope of the section financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group, and specifying additional disclosures for these contracts;
- relocating guidance on restructuring costs from the Appendix to the section and adding examples; and
- removing the example on customer refunds for the Appendix to the section as a consequence of the revised Section 23 *Revenue from Contracts with Customers*.

REQUIREMENTS AND EXAMPLES

Scope of this section

- 21.1 This section applies to all **provisions** (liabilities of uncertain timing or amount), **contingent liabilities** and **contingent assets** except those provisions covered by other sections of this Standard, which include provisions relating to:⁵
- (a) **leases** (Section 20 *Leases*). However, this section deals with **operating leases** that have become onerous.
 - (b) **revenue from contracts with customers** (Section 23 *Revenue from Contracts with Customers*). However, this section deals with contracts with customers that have become onerous.
 - (c) **employee benefit** obligations (Section 28 *Employee Benefits*).
 - (d) **income tax** (Section 29 *Income Tax*).
 - (e) contingent consideration of an **acquirer** in a **business combination** (Section 19 *Business Combinations and Goodwill*).

...

⁵ This section uses the term 'liability' in a way that differs in some respects from the definition in paragraph 2.49 and the Glossary. For the purpose of this section, 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.

Educational notes

Scope

The requirements of Section 21 do not apply to financial liabilities. Financial liabilities are accounted for by applying the requirements for financial instruments (see Section 11 *Financial Instruments*).

Section 19 addresses the treatment by an acquirer of contingent liabilities and contingent consideration in a business combination. Therefore, Section 21 does not apply to contingent liabilities and contingent consideration in a business combination.

The tax consequences of provisions, and the tax consequences of a change in the measurement of a provision after it is initially recognised, are dealt with under Section 29 *Income Tax*.

Definitions

Section 21 uses the term ‘liability’ in a way that differs in some respects from the definition in paragraph 2.49 of the Standard and the Glossary. Section 21 defines a liability as 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’.¹

A liability is a present obligation that may be either a legal obligation or a constructive obligation. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement. A constructive obligation is ‘an obligation that derives from an entity’s actions’ and is explained further in paragraph 21.6.

Provisions are liabilities of uncertain timing or amount. A provision is a kind of liability distinguished from other liabilities, such as trade payables and accruals, because they are characterised by uncertainty about the timing or amount of the future expenditure required in settlement. Trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced for or formally agreed with the supplier. Accruals are liabilities to pay for goods or services that have been received but have not yet been paid for or formally agreed with the supplier. Accruals may also relate to amounts due to employees. Although it is sometimes necessary to estimate the amount or timing of accruals, there is generally less uncertainty with accruals than provisions.

A contingent liability arises when (a) there is a possible obligation that arises from past events 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 or (b) there is a present obligation that arises from past events but either it is not probable that an outflow of resources representing 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 non-occurrence of one or more uncertain future events not wholly within the control of the entity.

21.1A This section applies to **financial guarantee contracts** issued at nil consideration when the specified debtor is another entity within the **group**. Other issued financial guarantee contracts are in the scope of Part II of Section 11 *Financial Instruments*.

Educational notes

The Glossary defines a financial guarantee contract as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. If the financial guarantee contract is issued without consideration and the specified debtor is another entity within the group—that is, a parent and its subsidiaries—the contract is within the scope of Section 21. For example, when a parent guarantees repayment of a loan issued by a bank to one of its subsidiaries for nil consideration, the financial guarantee contract is within the scope of Section 21.

¹ The Glossary defines a liability as a ‘present obligation of the entity to transfer an economic resource as a result of past events’.

-
- 21.2 The requirements in this section do not apply to **executory contracts** unless they are **onerous contracts**. Executory contracts are contracts under which neither party has fulfilled any of its obligations or both parties have partially fulfilled their obligations to an equal extent.
- 21.3 The word ‘provision’ is sometimes used in the context of such items as **depreciation**, impairment of **assets** and uncollectable receivables. Those are adjustments of the **carrying amounts** of assets, instead of **recognition** of liabilities, and therefore are not covered by this section.

Educational notes

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 provision should be recognised as the amount by which the unavoidable costs exceed the economic benefits.

The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of:

- the cost of fulfilling the contract; and
- any compensation or penalties arising from failure to fulfil the contract.

If an asset is no longer used, the provision represents the best estimate of the expenditure required to settle the obligation at the reporting date, which in this case might be the amount the lessor would accept to terminate the lease (or, in accordance with paragraph 21.7, the amount that ‘the entity would rationally pay to settle the obligation at the end of the reporting period’).

Long-term contracts to supply customers with goods when costs have risen or market prices have declined are onerous, and a provision is recognised, if and to the extent that future sales will be made at a loss. No provision is recognised under a contract for the supply of goods that is profitable, but at a reduced margin compared with other contracts.

Initial recognition

- 21.4 An entity shall recognise 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** (ie 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.

Educational notes

An entity recognises a provision when it has a present obligation to act or perform in a particular way and the costs of the required action are of uncertain timing or amount. Throughout this module, the recognition criterion in paragraph 21.4(a), specifically the phrase ‘obligation at the reporting date’, is used interchangeably with ‘present obligation’.

A provision should be recognised when three conditions are met: an entity has a present obligation (legal or constructive) as a result of a past event; it is probable that a transfer of economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met, no provision should be recognised.

Present obligation

In the rare cases in which it is not clear whether a present obligation exists, 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.

Past event

For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This will be the case only if the settlement of the obligation can be enforced by law or, in the case of a constructive obligation, the event creates valid expectations in other parties that the entity will discharge the obligation. The event may be an action of the entity. The only liabilities recognised in an entity’s balance sheet are those that exist at the balance sheet date.

If an entity can avoid future expenditure in its future actions, for example by changing its method of operation, it has no present liability for that future expenditure and no provision is recognised.

An event that does not immediately give rise to an obligation may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted.

Similarly, obligations that arise from future actions of an entity, no matter how likely, are not present obligations and therefore do not meet the definition of a provision or a liability. For example, an entity should not recognise a provision for expected future losses because the entity has no present obligation to incur those losses, as illustrated in paragraph 21A.1 of the Appendix to Section 21.² In such a case, the entity could end the operations that would generate the future losses. Note also that the expectation of losses may be an indicator that some of an entity's assets are impaired (see paragraph 27.9).

Recognition of impairment losses is covered by Section 27 *Impairment of Assets*. If an entity has entered into an onerous contract (see paragraph 21A.2 of the Appendix to Section 21), under which the entity has an unavoidable obligation to incur a loss, then a provision for that loss is appropriate because it arises from a past event—the entity entering into a binding contract—and not from avoidable future loss-making activities.

An entity does not have a liability if the obligating event has not taken place (see the additional example in paragraph 21A.8 of the Appendix to Section 21).

Probable transfer of economic benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of a transfer of economic benefits to settle that obligation. A transfer of economic benefits to settle an obligation is regarded as probable if the outflow is more likely than not to occur. Where there are a number of similar obligations (for example, product warranties or similar contracts), the probability that a transfer will be required in settlement is determined by considering the class of obligations as a whole.

Reliable estimate of the obligation

The use of estimates is an essential part of the preparation of financial statements and does not in itself undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than many other items in the statement of financial position.

An entity will normally 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. In the extremely rare case in which no reliable estimate of the obligation can be made, a liability exists that cannot be recognised. That liability is therefore disclosed as a contingent liability (see paragraph 21.12).

² The Appendix accompanies, but is not part of, Section 21. It provides guidance for applying the requirements of Section 21 in recognising and measuring provisions.

Examples—Provisions

Ex 1 Waste from an SME's production process contaminated the groundwater at the SME's plant. In a lawsuit brought against the SME, members of the local community seek compensation for damage to their health as a result of the contamination. The SME 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 SME's lawyers expect the decision in about two years, and they estimate that the compensation awarded by the court will be in the range CU1 million–CU30 million.³

The SME has a liability of uncertain timing or amount (a provision). At the end of the reporting period, the SME has a legal obligation to compensate members of the local community for the damage it caused. Because the court is deciding on the extent of compensation to be paid, its amount is uncertain. Furthermore, the uncertain timescale of the legal process brings uncertainty to the timing of the payment for damages.

Ex 2 Waste from an SME's production process contaminated the groundwater at the SME's plant. The entity is required by law to restore the contaminated environment.

The SME estimates that such restoration will cost between CU1 million and CU15 million. The SME is unsure of the date by which it will be required to complete the restoration.

The SME has a liability of uncertain timing or amount. At the end of the reporting period, it is obliged by law to restore the damage caused to the environment. There is uncertainty about the timing and amount of the cash flows to restore the environment.

Ex 3 A manufacturer gives warranties to its customers. 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.

On 31 January 20X1 a manufacturing defect was detected in the goods manufactured by the SME between 1 December 20X0 and 31 January 20X1.

At 31 December 20X0 (the SME's reporting date) the SME held approximately one week's sales in inventories.

The SME's financial statements for the year ended 31 December 20X0 have not yet been finalised.

Three separate categories of goods require separate consideration.

Category 1—Defective goods sold on or before 31 December 20X0

The obligating event is the sale of the product with a warranty. At 31 December 20X0 the SME has a legal obligation to make good the defective goods sold to its customers. The obligation is of uncertain timing or amount.

³ In this example, and in all other examples in this module, monetary amounts are denominated in currency units (CU).

Category 2—Defective goods held on 31 December 20X0

At 31 December 20X0 the SME did not have a present obligation to make good the unsold defective goods that it held in inventories. Accordingly, at 31 December 20X0 the SME should not recognise a provision relating to the defective inventories. However, the SME should test the inventories for impairment in accordance with Section 27.

For this category, the detection of the manufacturing defect in January 20X1 is an adjusting event after the end of the reporting period (see Section 32 *Events after the End of the Reporting Period*). It provides evidence of a manufacturing defect in inventories held at 31 December 20X0.

Category 3—Defective goods to be manufactured in 20X1

At 31 December 20X0 the SME did not have a present obligation to make good any defective goods that it might manufacture in the future. Accordingly, at 31 December 20X0 the SME should not recognise a provision in respect of the defective goods manufactured in 20X1.

For this category, the detection of the manufacturing defect in January 20X1 is a non-adjusting event after the end of the reporting period (see Section 32).

Examples—Not provisions

- Ex 4** An SME that operates and owns 10 petrol stations (along with the land on which they are built) chooses not to purchase fire insurance for those buildings and instead to self-insure against fire loss. The SME can estimate reliably the statistical probability of the occurrence and amount of expected fire loss (about CU100,000 once every 10 years). The SME wants to recognise a provision of CU10,000 and related expense each year for the next 10 years to reflect its expected loss. The SME's basis for this proposed accounting is 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.

The fact that the SME has retained the risk of fire does not create an obligation that is recognised as a provision. An SME that purchases insurance has paid to transfer its risk to a third party, and that payment is recognised as an asset (prepayment for services) on the date it is made. The payment is then recognised as an expense in profit or loss for the period over which the insurance coverage is consumed, regardless of whether there is a fire loss.

A fire at one of the stations would be an event that triggers an impairment test on the fire-damaged asset. The impairment test might result in the recognition of an impairment loss in profit or loss.

Ex 5 A ski-resort operator operates a weather-dependent business. Its earnings fluctuate from one year to the next depending primarily on the weather. The management and owners of the SME believe that, because of this volatility, it is prudent to defer recognition of a portion of the profit in a good year to an inevitable bad year by recognising a provision in good years and reversing the provision in bad years. Local income-tax law allows deferral of a portion of the profit in a good year to help ensure that ski-resort operators have enough cash to continue operating in bad years. The SME's management and owners recognise a provision in the financial statements equal to the amount that can be deferred for tax purposes.

At the end of a good year, the SME does not have an obligation to another party in expectation of a bad year. Therefore, the definition of a liability is not met because the SME does not have a present obligation.

An accrual that is allowed for local income tax purposes is not the same as an expense or liability to be recognised for financial reporting purposes. These items have a tax base but are not recognised as assets and liabilities in the statement of financial position (see paragraph 29.11) and so may result in a deferred tax asset or liability (see Section 29).

Ex 6 An SME operates an opencast mine in a jurisdiction whose environmental laws state that all mine shafts deeper than 10 metres should be entirely refilled a year after extraction is completed. Failure to do so leaves the relevant mining company liable to a substantial fine.

Geologists' reports suggest that the SME will be able to extract significant quantities of ore for at least 20 years. The ore is located 15 metres below the surface.

At 31 December 20X0 the SME has not started mining.

At 31 December 20X0 the SME does not have a present obligation. The SME can avoid both the cost of filling the mine and the fine by abandoning the mining operation before it digs shafts 10 metres deep.

At 31 December 20X1 the SME has sunk a shaft five metres deep. It is highly likely that the SME will mine beyond 10 metres in the future and therefore will be obliged to refill the shaft.

At 31 December 20X1, depending on the relevant facts and circumstances, the SME may conclude that:

- it does not have a present obligation because the shaft is fewer than 10 metres deep. It can avoid both the cost of refilling the shaft and the fine by abandoning the mining operation before it digs shafts that are deeper than 10 metres.
- it does have a present obligation because it has no realistic alternative to digging to more than 10 metres and therefore paying to refill the shaft. The present obligation at 31 December 20X1 is for the cost of refilling the five metres of shaft dug by that date.

At 31 December 20X2 the SME has sunk a shaft 12 metres deep.

At 31 December 20X2 a present obligation exists because the SME is required by law to refill the existing shaft because it is deeper than 10 metres. Furthermore, the entity has no realistic alternative to refilling the shaft (or paying the fine).

Examples—Initial recognition of provision

Ex 7 An SME is a manufacturer. It gives warranties at the time of sale to its customers. Under the terms of the contract, the SME undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. Based on experience, it is probable that there will be some claims under the warranties.

The best estimate of the amount required to settle the obligation (see paragraph 21.7) should be recognised as a provision when the SME provides the warranties (in this case, at the point of sale of the product). That amount is also included in profit or loss for the period over which the SME sold the products with warranties to its customers.

Example 4 explained that a provision is not recognised for self-insured losses that have not yet occurred, no matter how reliably measurable the amount may be, because until a potential fire or another self-insured event actually happens there is no past event to make the SME obligated for any outflow of resources. For warranties, however, there is a past event that obligates the SME to make repairs or replacements—the sale of products with a warranty.

Ex 8 In 20X5 a lawsuit was brought against an SME by a group of people collectively seeking compensation for damage to their health as a result of contamination to nearby land which they believed was caused by a leak of waste from the SME's production process. It is uncertain whether the SME is the source of the contamination because many entities operate in the same area producing similar waste, and so the source of the leak is unclear.

The SME denies any wrongdoing because it has taken precautions to avoid such leaks and so is defending the case. However, the SME cannot be certain that it has not caused the contamination and the source of the contamination will only become known after extensive testing.

The SME's lawyers expect a court decision in approximately two years. Up to the date of approval (authorisation) of the financial statements for the year ended 31 December 20X5, the SME's lawyers advise that it is probable that the SME will not be found liable. However, when the SME prepares its financial statements for the year ended 31 December 20X6, the SME has been found liable, and its lawyers advise that it is probable that the SME will be required to pay compensation.

At 31 December 20X5, the SME assesses, based on the evidence available when the financial statements were approved, that there is a possible but uncertain obligation. The uncertainty is high enough for the outflow of economic benefit to not be probable. No provision is recognised. The possible obligation is disclosed as a contingent liability unless the probability of any outflow is remote.

At 31 December 20X6 there is a present obligation and based on the evidence available, an outflow of resources embodying economic benefits in settlement is probable. Therefore, a provision is recognised for the best estimate of the amount required to settle the obligation.

21.5 The entity shall recognise the provision as a liability in the **statement of financial position** and shall recognise the amount of the provision as an **expense**, unless another section of this Standard requires the cost to be recognised as part of the cost of an asset such as **inventories** or **property, plant and equipment**.

Examples—Initial recognition of provision as part of the cost of an asset

Ex 9 An SME constructed an item of equipment for use in its manufacturing operations. The SME is required by law to dismantle the equipment at the end of its useful economic life, to prepare it for recycling and to deliver it to the local government’s recycling facility.

The obligation to dismantle and recycle arises from the construction of the equipment. The best estimate of the amount required to settle the obligation (see paragraph 21.7) should be recognised as a provision (a liability) when the equipment is constructed.

That amount is also included in the cost of the equipment (an asset) in accordance with paragraph 17.10(c) of Section 17 *Property, Plant and Equipment* instead of being included in profit or loss in the period of construction. The effect of doing so is to increase the cost of the asset (the item of equipment) by the same amount as the recognised provision. The additional amount added to the cost of the asset will be recognised as depreciation over the useful life of the asset. Depreciation of manufacturing equipment will generally be added to the cost of the inventories produced. The cost of the inventories produced will be recognised in profit or loss when the related revenue is recognised.

When the effect of the time value of money is material, the amount of a provision is the present value of the amount expected to be required to settle the obligation (see paragraph 21.7); and the subsequent unwinding of the discount is required to be recognised as finance cost in profit or loss (see paragraph 21.11). The finance cost is not an addition to the capitalised cost of the equipment.

Ex 10 Effluent released from an SME’s manufacturing process contaminates the land on which the SME operates. At the end of the plant’s useful life, the SME is required to restore the land.

The best estimate of the amount required to settle the obligation (see paragraph 21.7) should be recognised as a provision when the SME contaminates the land—the obligation to restore the environment arises from the manufacturing process.

21.6 The condition in paragraph 21.4(a) (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 (ie the future conduct of its business) do not satisfy the condition in paragraph 21.4(a), 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 recognised.

Educational notes

A liability is a present obligation which may be either a legal obligation or a constructive obligation.

A legal obligation is 'legally enforceable as a consequence of a binding contract or statutory requirement'. A constructive obligation is defined in the Glossary as an obligation that derives from an entity's actions when:

- (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 particular 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.

21.6A 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. Examples of events that may fall under the definition of restructuring:

- (a) sale or termination of a line of business;
- (b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
- (c) changes in management structure—for example, eliminating a layer of management; and
- (d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

continued ...

21.6B A constructive obligation to restructure arises only when an entity:

- (a) has a detailed formal plan for the restructuring identifying at least:
 - (i) the business or part of business concerned;
 - (ii) the principal locations affected;
 - (iii) the locations, function and approximate number of employees who will be compensated for termination of their services;
 - (iv) the expenditure that will be undertaken; and
 - (v) when the plan will be implemented.
- (b) 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.

Educational notes

In the case of restructuring, it requires more than management's intention for a present obligation to exist (and for a provision to be recognised) (see paragraph 21.6A). Intentions can change, and they are not past events that create an obligation for the entity. The obligation arises (and a provision is recognised) when those intentions become unavoidable commitments to pay out resources. For example, a constructive obligation is created in which a public announcement by an entity indicates to other parties that it will accept certain responsibilities and, as a result, the entity creates a valid expectation on the part of those other parties that it will discharge those responsibilities.

If the entity communicates and implements the restructuring after the end of the reporting period but before the financial statements are authorised for issue, it is required to disclose the fact as a non-adjusting event after the end of the reporting period (see paragraph 32.11(e)).

Paragraphs 21A.6 and 21A.7 in the Appendix to Section 21 illustrate how implementation of an entity's plan at the reporting date affects recognition of a provision.

Examples—Obligating event

Ex 11 An SME 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 SME appeared at a press conference to announce the pledge. With the SME's consent, the charitable organisation that is building the arts centre has cited the SME's pledge in its materials soliciting additional pledges for construction. Under local law, pledges to charitable organisations are not legally enforceable.

Although the pledge is not legally enforceable, by participating in the press conference and by allowing its name to be used in the solicitation, the SME has indicated that it has accepted an obligation to honour its pledge and has created a valid expectation on the part of the arts centre that it will do so (its actions have given rise to a constructive obligation). The SME recognises a provision.

Ex 12 Waste from an SME's production process contaminated the groundwater at the SME's plant. The SME is not required by law to restore the contaminated ground water and no claim has been asserted. However, before the end of the current reporting period, the SME publicly announced that it would restore the contaminated environment within the next 12 months.

The SME has declared to the public that it accepts responsibility to restore the contaminated environment and has therefore created a valid expectation on the part of the public that it will discharge this responsibility. Therefore, at the end of the reporting period, the SME has a constructive obligation to repair the damage caused to the ground water. There is uncertainty about the amount of the cash flows to restore the ground water. The SME has a liability of uncertain timing or amount (that is, a provision).

Initial measurement

21.7 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:

- (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. 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.
- (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. However, even in such a case, the entity considers other possible outcomes. When other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount than the most likely outcome.

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

Educational notes

Best estimate

The use of estimates is an essential part of the preparation of financial statements and does not undermine the usefulness of the information if an entity clearly and accurately describes and explains the estimates (see paragraph 2.73). This is also true in the case of provisions, which by their nature are more uncertain than most other items in the statement of financial position. Judgement may need to be exercised in measuring provisions, but in nearly all cases the measurement uncertainty is not too great for a reliable estimate to be made.

The best estimate of the expenditure required to settle a present obligation is the amount that 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. It might be impossible to transfer, or not economical to settle, an obligation at the end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The best estimate may be the cost of performing an obliged action (for example, decontamination) and is not necessarily always a payment.

An entity applies judgement in measuring the estimated settlement amount. Its judgement should reflect experience from similar transactions and consider any evidence that events after the reporting date but before the financial statements are authorised for issue provide about conditions that existed at the reporting date. Section 32 includes an example of an event after the reporting date—the settlement of a court case—that could affect the recognition and measurement of a provision (see paragraph 32.5(a)).

Future events

Future events that may affect the amount required to settle an obligation (for example, a future change in technology that would reduce the costs of restoring a site) are reflected in the amount of a provision only when there is enough objective evidence that those future events will occur. Therefore, an entity would not, for example, anticipate the development of a completely new technology.

Provisions are measured before tax.

Risks and uncertainties

The risks and uncertainties that surround many events and circumstances are taken into account in determining the best estimate of a provision. When risks specific to the liability are reflected in the estimate of the cash outflows required to settle the obligation, the appropriate discount rate is a risk-free rate. Alternatively, when the risks specific to a liability are not reflected in the estimation of the amounts required to settle the obligation, they are accounted for by adjusting the discount rate. (The appropriate discount rate will be a risk-free rate, such as a current government-bond rate minus an appropriate adjustment for risk.) To take those risks both as an adjustment to the cash flows and as an adjustment to the discount rate would mean double counting them.

Present value

In some cases it will be necessary to perform a discounted cash flow calculation to determine the present value of the settlement amount in order to assess whether the time value of money is material. In other cases it may be clear that adjusting for the time value of money would not affect the material information disclosed in the financial statements. This may be the case if, for example, the period until settlement is short. Because materiality is a matter of judgement, it is important to assess it in relation to the financial statements including the statement of financial position and the statement of comprehensive income (see paragraph 2.13 of Section 2 *Concepts and Pervasive Principles*).

The discount rate is required to be a pre-tax rate that reflects current market assessments of the time value of money. The rate could be based on the current yield from fixed-rate government bonds (rather than the coupon rate of the bond) if available. The yield on a government bond issued in the jurisdiction with the same currency and maturity date that approximates the timing of the expected cash flow is often indicative of the risk free rate for that cash flow. In the absence of government bonds in an entity's jurisdiction, the discount rate could be based on other references (for example, the yield on high-quality corporate bonds or term deposit rates—not loan rates—issued by banks in that jurisdiction). Instruments used as reference rates with different maturity dates may have different yields. When settlement of a provision is expected to take place at more than one date, different discount rates may apply to the amounts that are expected to be settled at the different dates.

Regardless of the reference used, either the discount rate or estimated cash outflows are adjusted in accordance with paragraph 21.7. In many cases, an entity may find it simpler to reflect risks specific to the liability in the estimation of cash outflows instead of adjusting the pre-tax risk-free discount rate.

Examples—Initial measurement

Ex 13 An SME's production process contaminates the land on which the SME's plant is built. The SME is required by law to restore the environment at the end of its plant's useful life of 10 years. The SME estimates clean-up costs in the range CU200,000–CU275,000.

After weighing the probabilities of the various clean-up cost scenarios, the expected cash outflows are estimated to be CU231,250. The SME increases these by 5%, which is the total amount it estimates a third party would charge to compensate it for the uncertainties. The SME discounts the risk-adjusted cash flows by the risk-free rate of 6% per year to reflect the time value of money. The result is that the provision is measured at CU135,586 ((CU231,250 × 1.05 risk adjustment) ÷ 1.06¹⁰ discount factor).

Ex 14 An SME sells 1,000 units of a product with warranties under which the SME 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 be incurred. If a major defect is detected in a product, estimated repair costs of CU400 will be incurred. The SME's experience adjusted to reflect changes in product design and manufacturing indicates that 75% of the goods sold have no defects, 20% of the goods sold have minor defects and 5% 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.

In accordance with paragraph 21.7(a), the best estimate of the amount of a provision that involves a large population of items reflects the weighting of all possible outcomes by their associated probabilities.

The expected value of the cost of repairs is: $(75\% \times 1,000 \text{ units sold} \times \text{nil}) + (20\% \times 1,000 \text{ units} \times \text{CU100}) + (5\% \times 1,000 \text{ units} \times \text{CU400}) = \text{CU40,000}$.

Therefore a provision of CU40,000 would be appropriate (ignoring the effect of discounting).

Ex 15 A customer has initiated a lawsuit against an SME. The customer alleges that he suffered personal injury from using one of the SME's products. The SME's lawyers estimate that the SME will be found responsible and that at the reporting date (31 December 20X1) the SME will likely be ordered to pay compensation of CU300,000.

The ruling is expected to be received in two years. The risk-free discount rate based on two-year government bonds is 5%. The SME determines that a discount rate of 4% is appropriate to adjust for the risks specific to the liability including consideration for uncertainty.

If the SME has assessed that the effect of the time value of money is material, the SME will measure its liability as the present value of CU300,000 discounted at 4% over two years. The SME would recognise a provision of approximately CU277,367^(a) at 31 December 20X1.

Calculation:

^(a) Risk-adjusted present value: $\text{CU300,000} \times (1 \div 1.04) \times (1 \div 1.04) = \text{CU277,367}$.

Ex 16 The facts are the same as in Example 15. However, in this example, the lawyers estimate that the SME will be found responsible and that the SME has a 25% chance of being ordered to pay the customer compensation of CU100,000, a 50% chance of being ordered to pay compensation of CU300,000 and a 25% 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.

The outcome of the case is expected to result in an outflow of CU100,000, CU300,000 or CU500,000. Paragraph 21.7(b) states that 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. Based on the facts, the individual most likely outcome is that compensation of CU300,000 will be paid.

Ex 17 The facts are the same as in Example 15. However, in this example, the lawyers estimate that the SME has a 60% chance of winning the lawsuit and thereby not having to pay compensation. Furthermore, the SME's lawyers estimate that the SME has a 20% chance of being found responsible and ordered to pay compensation of CU2 million, and a 20% chance of being found responsible and 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.

In this case, the SME does not recognise a provision in its statement of financial position because it does not have a present obligation that satisfies the recognition criteria in paragraph 21.4, because it is not probable (that is, more likely than not) that an outflow of economic benefits will be required. However, the SME has a contingent liability, which it would estimate using the requirements of paragraph 21.7 and disclose in accordance with paragraph 21.15.

Ex 18 The facts are the same as in Example 15. However, in this example, the lawyers estimate that the SME has a 25% chance of winning the lawsuit and thereby not having to pay compensation. Furthermore, the SME's lawyers, having reviewed a number of similar cases, estimate that the SME has a 35% chance of being found responsible and ordered to pay the customer compensation of CU300,000, a 20% chance of being found responsible and ordered to pay compensation of CU1 million, and a 20% chance of being found responsible and ordered to pay compensation of CU2 million.

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

The outcome of the case is expected to result in no compensation being awarded or, if the case is lost, an outflow of between CU300,000 and CU2 million. The individual most likely outcome is that compensation of CU300,000 will be paid to settle the obligation. It is probable that an outflow of economic benefits will be required.

Recognition of a provision is required. It would be appropriate for the SME to measure the amount of the provision on an expected value basis. The SME recognises a provision at 31 December 20X1 of approximately CU705,000 (its expected value).⁴

Calculation:

Expected value: $(CU0 \times 25\%) + (CU300,000 \times 35\%) + (CU1,000,000 \times 20\%) + (CU2,000,000 \times 20\%) = CU705,000$.

⁴ The individual most likely outcome is CU300,000. Because other possible outcomes are mostly higher than CU300,000, the best estimate will be different than the most likely outcome. To make the adjustment, this SME uses an expected value calculation. Other methods of adjustment that are consistent with the measurement principle—the amount that 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—are also acceptable.

-
- 21.8 An entity shall exclude gains from the expected disposal of assets from the measurement of a provision.
- 21.9 When some or all of the amount required to settle a provision may be reimbursed by another party (for example, through an insurance claim), the entity shall recognise 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 recognised 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. In the **statement of comprehensive income**, the entity may offset any reimbursement from another party against the expense relating to the provision.

Educational notes

Sometimes, an entity can look to a third party to pay part or all of the expenditure required to settle a provision—for example, through insurance contracts, indemnity clauses or suppliers' warranties. The third party may either reimburse amounts paid by the entity or pay the amounts directly.

In many cases, the entity will remain liable for the whole of the amount in question, and therefore would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability. When it is virtually certain that reimbursement will be received if the entity settles the liability, a separate asset is recognised for the expected reimbursement.

In some cases, the entity will not be liable for the amount in question if the third party fails to pay. In such a case the entity has no liability for those costs and they are not included in the provision.

Examples—Reimbursements

Ex 19 A retailer gives warranties at the time of sale to its customers. Under the terms of the contract for sale, the retailer undertakes to make good, by repair or replacement, any defects in the product (other than those caused by the customer) that become apparent within three years from the date of sale. Based on experience, it is probable that there will be some valid claims under the warranties it has provided on the products it sells.

The retailer receives warranties at the time of purchase of those products from the manufacturer. Under the terms of the contract for purchase, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three and a half years from the date of purchase.

The manufacturer has provided a warranty only against manufacturing defects, whereas the retailer's warranty also covers additional defects that arose while the product was in the retailer's possession.

On average, the retailer holds inventory for six months.

Accounting by the retailer

The retailer recognises the best estimate of the amount required to settle the warranty obligation (see paragraph 21.7(a)) as a provision at the time it makes a sale of its product. Whether and at what amount it recognises a related reimbursement asset receivable from the manufacturer depends on the terms of its contract with the manufacturer.

The terms of the contract under which the retailer bought the items obligate the manufacturer to make good, by repair or replacement, manufacturing defects that become apparent within three and a half years from the date of purchase by the retailer. If such manufacturing defects become apparent while the products are in the retailer's possession and the defective goods are returned by the retailer, then the retailer accounts for the return of inventory to the manufacturer. No reimbursement asset is recognised.

For manufacturing defects that become apparent after products are sold to the retailer's customers, the retailer recognises a reimbursement asset only for those defective products when it is virtually certain that the manufacturer will repair or replace the product when the retailer is obligated to repair or replace the product for its customers. The amount to be recognised by the retailer for the reimbursement asset relating to goods sold to the customers is not necessarily the same amount as it recognises for the warranty liability. For example, the manufacturer may not repair or replace the defective products for the retailer if it considers that the damage to the products was caused while the product was in the retailer's possession.

Accounting by the manufacturer

The manufacturer recognises the best estimate of the amount required to settle its own warranty obligation (see paragraph 21.7(a)) as a provision (a liability) when it sells the goods to the retailer.

Subsequent measurement

21.10 An entity shall charge against a provision only those expenditures for which the provision was originally recognised.

Educational notes

Only expenditures that relate to the original provision are set against the provision. When the provision is settled and the outcome is different from the amount of provision recognised in the financial statements, such difference is not a correction of an error—it is a revision of an estimate. However, it is a correction of an error if the difference is due to an error in a prior period (see paragraph 10.19 of Section 10 *Accounting Policies, Estimates and Errors*).

Examples—Expenditures charged against a provision

Ex 20 During 20X1 an SME was sued for environmental damage (Case A). At 31 December 20X1 the SME recognised a CU50,000 provision in respect of that lawsuit.

In September 20X2 Case A was dismissed without the right to appeal.

In December 20X2 an unrelated lawsuit for patent infringement (Case B) was brought against the SME. Later that month, the court ruled against the SME in Case B. In accordance with the verdict, the SME was ordered to pay the plaintiff damages of CU40,000.

In 20X2 the SME made the following journal entry in its accounting records to recognise these events:

December 20X2

Dr	Provision for lawsuit (liability)	CU50,000	
	Cr	Profit or loss	CU10,000
	Cr	Cash	CU40,000

To offset the reversal of the provision for Case A against the liability for Case B.

The above journal entry is incorrect. The SME must not charge the cost of the damages paid in Case B against the provision recognised for Case A.

The SME should have accounted for the events as follows:

September 20X2

Dr	Provision for lawsuit (liability)	CU50,000	
	Cr	Profit or loss	CU50,000

To recognise the change in an accounting estimate made in a prior period for the expected settlement of lawsuit Case A that was dismissed by the court in September 20X2.

December 20X2

Dr	Profit or loss	CU40,000	
	Cr	Cash	CU40,000

To recognise the settlement of Case B—Patent infringement.

An SME considers whether the two entries should be aggregated into a single line item in the financial statements (see paragraph 3.15 of Section 3 *Financial Statement Presentation*).

In this example, the effects of the increase during the period in the discounted amount arising from the passage of time have been ignored.

Ex 21 At 31 December 20X1 an SME recognised a CU400,000 provision for an announced restructuring of its operations.

In 20X2 the SME completed that restructuring at a lower-than-expected cost of CU350,000. The SME decided to utilise CU37,000 of the amount that had been provided for in relation to a lawsuit it recently lost.

The SME recorded the settlement of the lawsuit as follows:

Dr	Provision for restructuring (liability)	CU37,000	
	Cr	Cash	CU37,000

To recognise the settlement of a lawsuit.

The above journal entry is incorrect. The SME should not charge the cost of the lawsuit against the provision for the announced restructuring because the lawsuit was not a cost of restructuring. The SME should have accounted for the lawsuit as follows in the year ended 31 December 20X2 (assuming no provision was previously recognised):

Dr	Profit or loss	CU37,000	
	Cr	Cash	CU37,000

To recognise the settlement of a lawsuit.

After accounting for the effect of the increase during the period in the discounted amount of CU400,000 arising from the passage of time (see paragraph 21.11 and the related notes for an explanation), the amount of the provision for the announced restructuring not utilised in that restructuring is accounted for as a change in accounting estimate (see paragraph 10.16). The change in the estimate (leading to the reversal of the remaining provision) is recognised in profit or loss for the year ended 31 December 20X2.

21.11 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 recognised shall be recognised in **profit or loss** unless the provision was originally recognised as part of the cost of an asset (see paragraph 21.5). 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 recognised as a finance cost in profit or loss in the period it arises.

Educational notes

A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and accordingly are not corrections of errors (see paragraph 10.15).

The requirements of paragraph 21.11 for provisions are consistent with the requirements for accounting for changes in accounting estimates (see paragraph 10.16). Changes in accounting estimates are applied prospectively. However, if a prior period error (see paragraph 10.19) causes a change to be made to the recognised amount of an existing provision or causes a new provision to be recognised, then that error should be corrected retrospectively by restating the comparative amounts (see paragraph 10.21).

In estimating the amount of provisions, an entity reflects conditions that existed at the end of the reporting period if it obtains evidence of these conditions prior to the date that financial statements are authorised for issue. The requirements that define adjusting events after the end of the reporting period are covered in Section 32.

When discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. In other words, the present value of the obligation will increase as the liability becomes closer to settlement. The unwinding of the discount is recognised as a finance cost in profit or loss.

Examples—Adjustments to initial measurement of a provision

Ex 22 An SME recognised a provision for a lawsuit at CU40,000 in its statement of financial position at 31 December 20X1. At 31 December 20X2 the risk-adjusted present value of the best estimate of the amount required to settle the lawsuit is CU90,000. One reason that the provision has increased from CU40,000 is that the lawsuit is one year closer to settlement. CU3,000 of the increase is attributable to the unwinding of the discount and the remainder is the result of better information on which to base the estimates becoming available during 20X2.

At 31 December 20X2 the SME recognises a provision of CU90,000. The increase of CU50,000 will be recognised as an expense in determining the SME's profit or loss for the year ended 31 December 20X2. Of that CU50,000 expense, CU3,000 is presented as a finance cost and the remaining CU47,000 is presented as an expense from a lawsuit.

December 20X1

Dr	Profit or loss	CU40,000	
	Cr	Provision for lawsuit (liability)	CU40,000

To recognise the provision for the lawsuit.

December 20X2

Dr	Profit or loss	CU47,000	
Dr	Finance cost	CU3,000	
	Cr	Provision for lawsuit (liability)	CU50,000

To recognise the change in an accounting estimate made in a prior period.

Ex 23 The facts are the same as in Example 4 of the Appendix to Section 21.

In the example in the Appendix to Section 21, warranty costs at the end of 20X0 are estimated at CU46,000 and expected to be settled over three years. The estimated cash payments are discounted based on observable (risk-free) rates in the local market of 6% for a one-year bond and 7% for two-year and three-year bonds. The table shows the calculation of the present value at the end of 20X0.

Year	Estimated cash payments (CU)	Discount rate	Discount factor	Present value (CU)
20X1	27,600	6%	0.9434	26,038
20X2	13,800	7%	0.8734	12,053
20X3	4,600	7%	0.8163	3,755
	<u>46,000</u>			<u>41,846</u>

This example illustrates how the provision would change in 20X1, assuming that the cash flow estimates and discount rates remain unchanged.

The present value at the end of 20X1 would be:

Year	Estimated cash payments (CU)	Discount rate	Discount factor	Present value (CU)
20X2	13,800	6%	0.9434	13,019
20X3	4,600	7%	0.8734	4,018
	<u>18,400</u>			<u>17,037</u>

The reduction in the provision from CU41,846 to CU17,037 results from three changes.

The first change is the result of unwinding the discount by one year. The unwinding of the discount is calculated as the product of each stream of cash flows and the respective rates used to discount them:

Year	Present value (CU)	Discount rate	Unwinding of discount (CU)
20X1	26,038	6%	1,562
20X2	12,053	7%	844
20X3	3,755	7%	263
	<u>41,846</u>		<u>2,669</u>

The second change is that the provision would no longer include the expected warranty costs for 20X1. These have now been paid.

The third change arises because the estimated cash payments at the end of 20X2 would now be discounted at the rate applicable for one-year bonds (6%), rather than the rate applicable for two-year bonds (7%). If the cash flows at the end of year 20X2 were discounted at 7%, they would have a present value of CU12,897 at the end of 20X1, CU122 lower than the CU13,019 previously calculated.

Example 28 illustrates the reconciliation of the opening and closing balances that would be disclosed for this fact pattern.

Contingent liabilities

21.12 A contingent liability is either a possible but uncertain obligation or a present obligation that is not recognised because it fails to meet one or both of the conditions (b) and (c) in paragraph 21.4. An entity shall not recognise a contingent liability as a liability, except for contingent liabilities assumed in a business combination applying paragraph 19.19. Disclosure of a contingent liability is required by paragraph 21.15 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.

Educational notes

Paragraph 21.12 describes two types of contingent liability:

- (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; and
- (b) a present obligation that arises from past events and that is not recognised as a liability because either 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 estimated reliably.

An obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties. The entity recognises a provision for the part of the obligation that it will have to settle using its own resources if the recognition criteria are met—that is, if it is probable that the entity will be required to transfer economic benefits to settle its obligation and the amount of the obligation can be estimated reliably.

Paragraph 19.19 requires an acquirer to recognise a contingent liability assumed in a business combination if a present obligation exists and the fair value of the contingent liability can be measured reliably (see Section 19 *Business Combinations and Goodwill*).

Relationship between provisions and contingent liabilities

When, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation and:

- *if there is a present obligation that probably requires an outflow of resources*—a provision is recognised (see paragraph 21.4). Disclosure of the provision is required (see paragraph 21.14).
- *if there is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources*—no provision is recognised (see paragraph 21.12). Disclosure of the contingent liability is required (see paragraph 21.15).
- *if there is a possible obligation or a present obligation for which the likelihood of an outflow of resources is remote*—no provision is required (see paragraph 21.12). No disclosure is required (see paragraph 21.15).

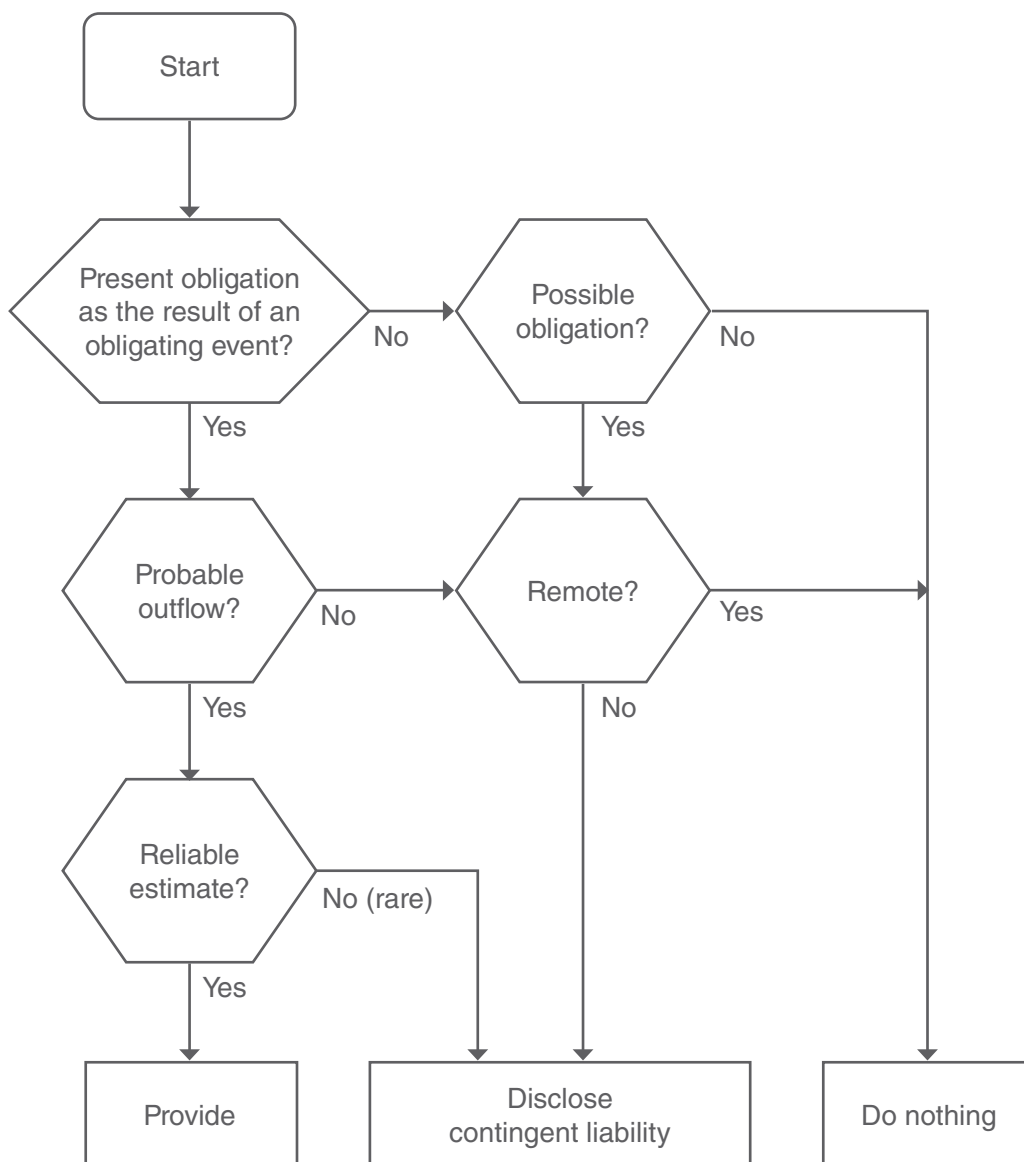
A possible obligation is an obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

A liability is treated as a contingent liability if it is a liability that is not recognised because it cannot be measured reliably. Disclosures are required for the contingent liability (see paragraph 21.15).

The decision tree from the implementation guidance of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is reproduced to illustrate how provisions and contingent liabilities are accounted for.

The same process applies under Section 21.

Diagram 1—How to account for provisions and contingent liabilities



Example—Contingent liabilities

Ex 24 In 20X5 a lawsuit was brought against an SME by a group of people collectively seeking compensation for damage to their health because of contamination to nearby land which they believed was caused by a leak of waste from the SME's production process.

Many businesses operate in the same area and produce similar waste, so it is uncertain whether the SME caused the contamination. The SME denies any wrongdoing because it has taken precautions to avoid such leaks, and so it is defending the case. However, the SME cannot be certain that it has not caused the contamination and the source of the contamination will become known only after extensive testing.

The SME's lawyers expect a court decision in about two years. Up to the date of approval (authorisation) of the financial statements for the year ended 31 December 20X5, the SME's lawyers advise that it is probable that the SME will not be found liable. However, when the SME prepares its financial statements for the year ended 31 December 20X6, the SME has been found liable, and its lawyers advise that it is probable that the SME will be required to pay compensation.

When it prepares its financial statements for the year ended 31 December 2025, the SME has a possible obligation if, considering all of the available evidence, it is probable that the SME will successfully defend the court case. In such circumstances, the SME is deemed not to have a present obligation; it instead has only a contingent liability.

If, considering all of the available evidence, it is probable that the SME will lose the court case, the SME is considered to have a present obligation. If the amount of the obligation can be measured reliably, the SME recognises a provision.

It may not be certain whether the SME has a present obligation, depending on the court decision. When it is not clear whether there is a present obligation (or a possible obligation), a past event is deemed to give rise to a present obligation (see paragraph 21.4(a)) if, considering all available evidence, it is probable that a present obligation exists at the reporting date.

By the time the SME prepares its financial statements for the year ended 31 December 2026 it knows it has a probable cash outflow relating to the past events and therefore recognises a provision.

Example 9 in paragraph 21A.9 in the Appendix to Section 21 also illustrates the relationship between provisions and contingent liabilities.

Contingent assets

21.13 An entity shall not recognise a contingent asset as an asset. Disclosure of a contingent asset is required by paragraph 21.16 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.

Educational notes

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.

Contingent assets usually arise from unplanned or other unexpected events that create the possibility of an inflow of economic benefits to the entity. However, when the realisation of income is virtually certain, the related asset is not a contingent asset and it is recognised as an asset.

Relationship between assets and contingent assets

When, as a result of past events, there is a possible asset 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 and:

- *if the inflow of economic benefits is virtually certain*—the asset is recognised and is not contingent (see paragraph 21.13);
- *if the inflow of economic benefits is probable, but not virtually certain*—no asset is recognised (see paragraph 21.13) and disclosure is required (see paragraph 21.16); or
- *if the inflow is not probable*—no asset is recognised (see paragraph 21.13) and no disclosure is required (see paragraph 21.16).

Examples—Contingent assets

Ex 25 An SME is taking legal action against its competitor seeking damages for patent infringement. The outcome of the case is uncertain. However, it is probable that the court will order the competitor to pay damages to the SME.

The SME expects to receive economic benefits from past events, because it considers it probable that the court will order the competitor to pay the SME damages. However, the existence of that benefit will only be confirmed by the occurrence of a future event outside the SME's control (the court decision).

The SME has a contingent asset. It arises from a past event (alleged patent infringement) whose existence will be confirmed by an uncertain event (successful legal action).

The SME should disclose the contingent asset, in the terms required by paragraph 21.16, because an inflow of economic benefits is probable, but not virtually certain.

Ex 26 The facts are the same as in Example 25. However, in this example, it is virtually certain that the court will order the competitor to pay damages to the SME.

The SME has a virtually certain future benefit arising from the court ordering the competitor to pay the SME damages. The existence of that benefit will only be confirmed by the occurrence of a future event outside the SME's control (the court decision). However, the receipt of the benefit is virtually certain, so the SME will recognise an asset.

The SME should recognise an asset. It is not a contingent asset because it is virtually certain that the SME will receive benefits, which removes the contingency.

Ex 27 The facts are the same as in Example 25. However, in this example, it is probable that the SME's case will not be successful.

The SME has a potential future benefit arising from the court ordering the competitor to pay the SME damages. The existence of that benefit will only be confirmed by the occurrence of a future event outside the SME's control (the court decision). However, the receipt of the benefit is not virtually certain, so the SME does not have an asset; it is also not probable, so the SME does not have a contingent asset.

An asset should not be recognised. Because the inflow of economic benefits is not probable, a contingent asset is not disclosed.

Disclosures

Disclosures about provisions

21.14 For each class of provision, an entity shall disclose all of the following:

- (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; and
- (d) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Comparative information for prior periods is not required.

Examples—Disclosures about provisions

Ex 28 The facts are the same as Example 23. In this example, the warranty payments equal those estimates. At the end of 20X1 the reconciliation required by paragraph 21.14 is as follows:

	<i>CU</i>
Carrying amount, end of 20X0	41,846
Add finance cost, unwinding of discount	2,669
Less warranty payments in 20X1	(27,600)
Other adjustment	122
Carrying amount, end of 20X1	<u>17,037</u>

The other adjustment is a result of the difference in the discount rates used when the amounts were discounted at the end of 20X0 and 20X1.

Ex 29 An SME could disclose information about its provisions as follows:

Note 2 Accounting policies
<p><i>Provisions</i></p> <p>A provision is recognised when the entity has a present obligation as a result of a past event, it is probable that the entity will be required to transfer economic benefits in settlement of the obligation, and the amount of the obligation can be estimated reliably. A provision is measured at the best estimate of the amount required to settle the obligation at the reporting date. It is determined by taking into account any risks and uncertainties relating to the obligation and discounted to reflect the time value of money by using a pre-tax risk-free discount rate based on government bonds with the same term as the expected cash outflows.</p>

Note 22 Provisions	<i>Warranties CU</i>	<i>Decommissioning CU</i>	<i>Total CU</i>
Carrying amount at 31 December 20X1	20,000	40,000	60,000
Unwinding of the discount	1,000	3,000	4,000
Additions	90,000	–	90,000
Settled in the period	(40,000)	–	(40,000)
Unused amounts reversed	(10,000)	(8,000)	(18,000)
Carrying amount at 31 December 20X2	61,000	35,000	96,000
Analysed as follows:			
Current	40,000	–	40,000
Non-current	21,000	35,000	56,000
	<u>61,000</u>	<u>35,000</u>	<u>96,000</u>

Product warranties

A provision is recognised for expected claims on products sold with a two-year warranty. The entity undertakes to make good, by repair or replacement, manufacturing defects that become apparent within two years from the date of sale. The carrying amount of the warranty provision is estimated at the end of the reporting period using probability-weighted expected values based on experience (that is, based on costs of repairs and replacements incurred in previous years, adjusted for uncertainties), taking into account any circumstances that have affected product quality. Product warranties are generally settled by the entity six months from the time reported by the customers.

Decommissioning

A provision is recognised for the legal obligation to decommission the chemical manufacturing plant at Place X in Jurisdiction Y. The entity intends to employ the service of a third party to do the decommissioning. The carrying amount of the decommissioning provision is estimated at the end of the reporting period using published industry-benchmark information for similar projects in Jurisdiction Y. However, adjustments are made to take into account the effect of new technology, the development of which is nearing completion, because there is enough objective evidence to suggest that such technology will be ready for commercial use by the time that the entity's plant needs to be decommissioned. If this technology were not taken into account, the amount of the provision would be 10% higher. Furthermore, the government of Jurisdiction Y is currently reviewing its environmental legislation. Current legislation requires only that the plant be decommissioned. The environmental review might result in legislative changes that would require entities to decontaminate any affected land surrounding a plant. However, because the law has not been changed, the effect of this expected change in legislation is not included in the carrying amount of the provision.

Disclosures about contingent liabilities

- 21.15 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, measured in accordance with paragraphs 21.7–21.11;
 - (b) an indication of the uncertainties relating to the amount or timing of any outflow; and
 - (c) the possibility of any reimbursement.

If it is **impracticable** to make one or more of these disclosures, that fact shall be stated.

Educational notes

If disclosure of the estimated financial effect of a contingent liability is required, it is measured in the same way as a provision—the best estimate of the amount that would be required to settle it at the reporting date (see paragraphs 21.7–21.11).

It is impracticable to apply a requirement if it cannot be applied after making every reasonable effort to do so (see the Glossary).

Example—Disclosures about contingent liabilities

Ex 30 An SME could disclose information about its contingent liabilities as follows:

Note 30 Contingent liabilities

A customer has begun legal proceedings against the entity, alleging personal injury resulting from use of the entity's products. The customer has claimed compensation of CU2 million. Based on legal advice, management has concluded that the claim has no merit and expects the court will rule in favour of the entity, with no compensation being awarded to the customer. Management has been advised that, if the courts unexpectedly rule in favour of the customer, the compensation awarded would probably be less than CU300,000.

Disclosures about contingent assets

- 21.16 If an inflow of economic benefits is probable (more likely than not) 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, unless it would involve undue cost or effort, an estimate of their financial effect, measured using the principles set out in paragraphs 21.7–21.11. If such an estimate would involve undue cost or effort, the entity shall disclose that fact and the reasons why estimating the financial effect would involve undue cost or effort.

Educational notes

When developing disclosures about contingent assets, an entity considers how to provide useful information without overstating expectations for future income.

Example—Disclosures about contingent assets

Ex 31 An SME could disclose information about its contingent assets as follows:

Note 31 Contingent assets

In 20X2 the company instigated legal proceedings against Entity B for damage to its aircraft caused by defective aviation fuel produced by Entity B.

The company's lawyers believe that it is probable that Entity B will be found responsible and that damages of CU60,000 will be awarded by the court.

No asset is recognised in the financial statements for this contingent asset, the existence of which is dependent upon the outcome of the legal proceedings.

Prejudicial disclosures

- 21.17 In extremely rare cases, disclosure of some or all of the information required by paragraphs 21.14–21.16 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Educational notes

In extremely rare cases, an entity is permitted to make specific alternative disclosures (see paragraph 21.17) if disclosure of the information in paragraphs 21.14–21.16 can prejudice seriously the position of the entity. However, no relief is provided from the recognition and measurement requirements for provisions; in the case of a provision, the entity recognises the provision and measures it at the best estimate of the amount required to settle the obligation at the reporting date.

Example—Prejudicial disclosures

Ex 32 An SME is involved in a dispute with a competitor, who is alleging that the SME has infringed patents and is seeking compensation of CU800,000. The SME recognised a provision for its best estimate of the obligation. The SME determines that the disclosures required by paragraphs 21.14–21.16 can prejudice seriously the SME’s position. The SME could include the following descriptive paragraph in its financial statements:

Litigation is in process against the SME relating to a dispute with a competitor which alleges that the SME has infringed patents and is seeking damages of CU800,000. The information usually required by paragraphs 21.14–21.16 is not disclosed because it can be expected to prejudice seriously the outcome of the litigation.

Disclosures about financial guarantee contracts

- 21.18 An entity shall disclose for issued financial guarantee contracts in the scope of this section (see paragraph 21.1A):
- (a) the nature and business purpose of these contracts;
 - (b) an indication of the uncertainties relating to the amount or timing of any outflow of resources; and
 - (c) the maximum amount the entity could be required to pay if the guarantees are called on.
- 21.19 An entity shall also make the disclosures required by Section 33 *Related Party Disclosures* and, if applicable, the disclosures required by paragraphs 21.14 and 21.15.

Educational notes

The disclosures required for financial guarantee contracts within the scope of Section 21 provide information about the nature, uncertainties and maximum amount that the entity might pay if the guarantees are called upon. Because the financial guarantee contracts are between entities in the same group, entities are required to disclose the information required by Section 33 *Related Party Disclosures* as well as the disclosures required by paragraphs 21.14 and 21.15, if applicable.

Example—Disclosures about financial guarantee contracts

Ex 33 An SME could disclose information about its financial guarantee contracts as follows:

Note 32 Financial guarantee contracts

The entity has issued a financial guarantee to Bank X for a loan granted to its subsidiary, Subsidiary A. The entity has guaranteed Subsidiary A's bank loan of up to CU300,000 to support the subsidiary's research and development activities. A payment under the guarantee would be required if Subsidiary A fails to make payment in terms of the loan agreement. As at the reporting date, Subsidiary A has not failed to make its payments on the loan. However, the timing and amount of any outflow remain uncertain because they depend on the future financial performance of Subsidiary A. Management considers the likelihood of payment under the guarantee to be low. The maximum amount that the entity could be required to pay if the guarantee is called upon is CU200,000.

Appendix to Section 21

Illustrative examples

This appendix accompanies, but is not part of, Section 21. The examples illustrate how to apply the requirements in Section 21 when recognising and measuring provisions.

All of the entities in the examples in this Appendix have 31 December as their reporting date. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets; this aspect is not dealt with in the examples. References to 'best estimate' are to the present value amount, when the effect of the time value of money is material.

Example 1 Future operating losses

21A.1 An entity determines that it is probable that a segment of its operations will incur future operating losses for several years.

Present obligation as a result of a past obligating event—there is no past event that obliges the entity to pay out resources.

Conclusion—the entity does not recognise a provision for future operating losses. Expected future losses do not meet the definition of a liability. The expectation of future operating losses may be an indicator that one or more assets are impaired—see Section 27 *Impairment of Assets*.

Example 2 Onerous contracts

21A.2 An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. For example, an entity may be contractually required under an operating lease to make payments to lease an asset for which it no longer has any use.

Present obligation as a result of a past obligating event—the entity is contractually required to pay out resources for which it will not receive commensurate benefits.

Conclusion—if an entity has a contract that is onerous, the entity recognises and measures the present obligation under the contract as a provision.

Example 3 Restructurings

21A.3 [Deleted]

Example 4 Warranties

21A.4 A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On the basis of experience, it is probable (ie more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event—the obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement—probable for the warranties as a whole.

Conclusion—the entity recognises a provision for the best estimate of the costs of making good under the warranty products sold before the reporting date.

Illustration of calculations:

In 20X0, goods are sold for CU1,000,000. Experience indicates that 90 per cent of products sold require no warranty repairs; 6 per cent of products sold require minor repairs costing 30 per cent of the sale price; and 4 per cent of products sold require major repairs or replacement costing 70 per cent of sale price. Consequently, estimated warranty costs are:

CU1,000,000 × 90% × 0	= CU0
CU1,000,000 × 6% × 30%	= CU18,000
CU1,000,000 × 4% × 70%	= CU28,000
Total	= CU46,000

The expenditures for warranty repairs and replacements for products sold in 20X0 are expected to be made 60 per cent in 20X1, 30 per cent in 20X2 and 10 per cent in 20X3, in each case at the end of the period. Because the estimated cash flows already reflect the probabilities of the cash outflows, and assuming there are no other risks or uncertainties that must be reflected, to determine the present value of those cash flows the entity uses a 'risk-free' discount rate based on government bonds with the same term as the expected cash outflows (6 per cent for one-year bonds and 7 per cent for two-year and three-year bonds).

Calculation of the present value, at the end of 20X0, of the estimated cash flows related to the warranties for products sold in 20X0 is as follows:

Year		Expected cash payments (CU)	Discount rate	Discount factor	Present value (CU)
1	60% × CU46,000	27,600	6%	0.9434 (at 6% for 1 year)	26,038
2	30% × CU46,000	13,800	7%	0.8734 (at 7% for 2 years)	12,053
3	10% × CU46,000	4,600	7%	0.8163 (at 7% for 3 years)	3,755
Total					41,846

The entity will recognise a warranty obligation of CU41,846 at the end of 20X0 for products sold in 20X0.

Example 5 Refunds policy

21A.5 [Deleted]

Example 6 Closure of a division—no implementation before end of reporting period

21A.6 On 12 December 20X0 the board of an entity decided to close down a division. Before the end of the reporting period (31 December 20X0) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

Present obligation as a result of a past obligating event—there has been no obligating event, and so there is no obligation.

Conclusion—the entity does not recognise a provision.

Example 7 Closure of a division—communication and implementation before end of reporting period

21A.7 On 12 December 20X0 the board of an entity decided to close a division making a particular product. On 20 December 20X0 a detailed plan for closing the division was agreed by the board, letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

Present obligation as a result of a past obligating event—the obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement—probable.

Conclusion—the entity recognises a provision at 31 December 20X0 for the best estimate of the costs that would be incurred to close the division.

Example 8 Staff retraining as a result of changes in the income tax system

21A.8 The government introduces changes to the income tax system. As a result of those changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with tax regulations. At the end of the reporting period, no retraining of staff has taken place.

Present obligation as a result of a past obligating event—the tax law change does not impose an obligation on an entity to do any retraining. An obligating event for recognising a provision (the retraining itself) has not taken place.

Conclusion—the entity does not recognise a provision.

Example 9 A court case

21A.9 A customer has sued Entity X, seeking damages for injury the customer allegedly sustained from using a product sold by Entity X. Entity X disputes liability on grounds that the customer did not follow directions in using the product. Up to the date the board authorised the financial statements for the year to 31 December 20X1 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 December 20X2, its lawyers advise that, owing to developments in the case, it is now probable that the entity will be found liable:

(a) at 31 December 20X1

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 20X2

Present obligation as a result of a past obligating event—on the basis of the evidence available, there is a present obligation. The obligating event is the sale of the product to the customer.

An outflow of resources embodying economic benefits in settlement—probable.

Conclusion—a provision is recognised at the best estimate of the amount to settle the obligation, and the expense is recognised in profit or loss. It is not a correction of an error in 20X1 because, on the basis of the evidence available when the 20X1 financial statements were approved, a provision should not have been recognised at that time.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs Accounting Standard* to transactions or other events often requires an entity to use its judgement. Information about significant judgements made by an entity's management and key sources of estimation uncertainty are useful to a user of financial statements assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6 of Section 8 *Notes to the Financial Statements*, an entity must disclose the judgements that management has made when applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, in accordance with paragraph 8.7, an entity discloses information that explains key assumptions about the future and other key sources of estimation uncertainty at the reporting date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the Standard require disclosure of information about particular judgements and estimation uncertainties.

Initial recognition

In accordance with Section 21, an entity must determine whether a present obligation that an entity has at the reporting date as a result of a past event gives rise to a provision or a contingent liability. This distinction is important because provisions are recognised in the statement of financial position while contingent liabilities generally are not.⁵ Usually it is not difficult to determine whether a present obligation requires recognising a provision. However, in some cases significant judgement may be necessary in evaluating whether the criteria to recognise a liability are satisfied.

Existence of a present obligation

When it is not clear whether there is a present obligation (or a possible obligation), a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is probable that a present obligation exists at the reporting date. In such cases, significant judgement may need to be exercised in evaluating the available evidence—such as the opinion of experts or additional evidence from events occurring after the reporting period—to determine whether it is probable that a present obligation exists at the reporting date. Significant judgement may also need to be exercised in determining whether a constructive obligation for restructuring exists and whether a restructuring provision should be recognised. Judgement will need to be exercised to assess whether the entity has a detailed formal plan for the restructuring and whether the entity has raised a valid expectation in those affected that the restructuring will be carried out.

⁵ An exception is made for contingent liabilities of an acquiree in a business combination.

More likely than not an outflow of benefits will be required

The cut-off for the probability-recognition criteria set out in paragraph 21.4(b) ('more likely than not') can be challenging in classifying present obligations that are only marginally more (or less) likely than not. In some cases, significant judgement may be required to determine whether a marginal outcome is more likely than not.

Ability to measure reliably

Except in extremely rare cases, an entity usually should be able to determine a range of possible outcomes and therefore make an estimate of the obligation that is reliable enough to use in recognising a provision. In some cases, significant judgement may be required to determine whether the obligation can be measured reliably enough to recognise a provision.

Measurement

Provisions are recognised and measured at the best estimate of the amount required to settle the present 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. As discussed in this module, the use of estimates is an essential part of the preparation of financial statements and does not in itself undermine their reliability.

Disclosure

Although not recognised in the statement of financial position, in specific circumstances, estimates of the financial effect of contingent liabilities are disclosed in the notes. Because of the uncertainties inherent in contingent liabilities, significant judgements may be required in some cases to identify the financial effects to be disclosed.

TRANSITION REQUIREMENTS

The third edition of the *IFRS for SMEs Accounting Standard* (the Standard) is effective for annual reporting periods beginning on or after 1 January 2027. Early application is permitted. Changes made to Section 21 from the second edition of the Standard are summarised on page 6.

An entity is required to retrospectively apply the amendments to Section 7 in accordance with Section 10. Retrospective application means applying an accounting policy to transactions, other events and conditions as if that policy had always been applied.

COMPARISON WITH FULL IFRS ACCOUNTING STANDARDS

The requirements in full IFRS Accounting Standards (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) and those in the *IFRS for SMEs* Accounting Standard (see Section 21) differ as at February 2025. The main differences are that the *IFRS for SMEs* Accounting Standard:

- is drafted in simpler language than that used in full IFRS Accounting Standards; and
- includes significantly less guidance on how to apply the principles in full IFRS Accounting Standards.

The following table lists the disclosure requirements in IAS 37 and maps them to the similar requirement in Section 21. An 'X' mark is given for disclosure requirements where there is no similar requirement in Section 21.

IAS 37 paragraph(s)	Section 21 paragraph(s)
84	21.14(a)
85	21.14(b)–(d), 21.18(a)–(b)
86	21.15
91	X
88	X
89	21.16
92	21.17
X	21.18(c)
X	21.19

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements in Section 21 *Provisions and Contingencies* of the *IFRS for SMEs* Accounting Standard by answering the questions provided.

Assume all amounts mentioned are material.

Once you have completed the test, check your answers against those supplied on page 55.

Mark the box next to the most correct statement.

Question 1

A provision is:

- (a) a liability of uncertain timing or amount.
- (b) a possible obligation as a result of past events that is of uncertain timing or amount.
- (c) an adjustment to the carrying amount of assets (for example, attributable to impairment or uncollectability).

Question 2

An entity recognises 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 (more likely than not) that the entity will be required to transfer economic benefits in settlement.
- (c) the amount of the obligation can be estimated reliably.
- (d) (a), (b) and (c) are true.
- (e) only (a) and (b) are true.

Question 3

An entity measures a provision at the best estimate of the amount required to settle the obligation at the reporting date. When the provision involves a large population of items, the estimate of the amount:

- (a) reflects the weighting of all possible outcomes by their associated probabilities.
- (b) is determined to be the individual most likely outcome.
- (c) may be the individual most likely outcome, but the entity should also consider the other possible outcomes.

Question 4

An entity measures a provision at the best estimate of the amount required to settle the obligation at the reporting date. When the provision arises from a single obligation, the estimate of the amount:

- (a) reflects the weighting of all possible outcomes by their associated probabilities.
- (b) is determined to be the individual most likely outcome.
- (c) is the individual most likely outcome adjusted to take account of the effect of other possible outcomes.

Question 5

An entity applies which section of the Standard to financial guarantee contracts issued at nil consideration when the specified debtor is another entity within the group?

- (a) Section 11 *Financial Instruments*
- (b) Section 33 *Related Party Disclosures*
- (c) Section 21 *Provisions and Contingencies*

Question 6

An SME is the defendant in a patent-infringement lawsuit. The SME's lawyers believe there is a 30% chance that the court will dismiss the case and the entity will incur no outflow of economic benefits. However, if the court rules in favour of the claimant, the lawyers believe that there is a 20% chance that the SME will be required to pay damages of CU200,000 (the amount sought by the claimant) and an 80% chance that the SME will be required to pay damages of CU100,000 (the amount that was recently awarded by the same judge in a similar case). Other outcomes are unlikely.

The court is expected to rule in late December 20X2. There is no indication that the claimant will settle out of court.

Management calculate the best estimate of the provision using the probability-weighted expected cash flows. A 7% risk-adjustment factor to the probability-weighted expected cash outflows is considered appropriate to reflect the uncertainties in the cash flow estimates.

An appropriate discount rate is 10% per year.

At 31 December 20X1 the SME recognises a provision for the lawsuit measured at:

- (a) CU0.
- (b) CU100,000.
- (c) CU89,880.
- (d) CU81,709.

Question 7

The facts are the same as in Question 6. However, in this question, because of extremely rare circumstances, disclosure of some of the information about the case required by paragraphs 21.14–21.16 can be expected to prejudice seriously the position of the SME in the dispute over the alleged breach of patent.

At 31 December 20X1 the SME:

- (a) would not recognise a provision and would disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.
- (b) would recognise a provision measured at the amount determined in the answer to Question 6 and would disclose the general nature of the dispute, together with the fact that, and the reason why, the information required by paragraphs 21.14–21.16 has not been disclosed.
- (c) would recognise a provision measured at the amount determined in the answer to Question 6 and would disclose the information required by paragraphs 21.14–21.16.

Question 8

The facts are the same as in Question 6. However, in this question, the SME's lawyers believe there is a 60% chance that the court will dismiss the case and the SME will incur no outflow. At 31 December 20X1 the entity:

- (a) recognises a provision measured at CU100,000.
- (b) recognises a provision measured at CU48,000.
- (c) recognises a provision measured at CU46,691.
- (d) discloses a contingent liability (and does not recognise a provision in its statement of financial position).

Question 9

On 20 February 20X5, before an SME's 31 December 20X4 financial statements were authorised for issue, a court ordered the SME to pay CU120,000 damages in full and final settlement of a patent-infringement lawsuit brought against the SME by one of its competitors. The patent infringement occurred in 20X3. The amount of damages awarded to the competitor was significantly higher than the CU10,000–CU30,000 range that the SME had expected to pay throughout the duration of the case based on precedent from similar cases and advice from their lawyers. The SME will not contest the judgement.

In its 31 December 20X3 annual financial statements, the SME measured its liability for the lawsuit at CU20,000—this estimate was appropriately made taking account of all available evidence at the time the financial statements were authorised for issue.

In its 31 December 20X4 financial statements the SME:

- (a) restates the comparative information as at 31 December 20X3 (retrospectively restates a prior period error).
- (b) measures the provision as at 31 December 20X4 at CU120,000 (where the comparative information for 20X3 is CU20,000) (changes its accounting estimate for its 20X4 financial statements).
- (c) measures the provision as at 31 December 20X4 at CU20,000 (where the comparative information for 20X3 is CU20,000) and records the effect of the higher-than-expected settlement in profit or loss for the year ended 31 December 20X5 (accounts prospectively for the change in accounting estimate in the period that the final settlement amount was determined).

Question 10

At 31 December 20X1 an SME is pursuing a legal claim against an insurance company. The court is expected to rule in late December 20X2. At the reporting date (31 December 20X1) the outcome of the case is uncertain.

The SME's lawyers believe there is a 70% chance that the SME will win the case. Furthermore, they believe that there is a 20% chance that the SME will be awarded CU200,000 (the amount sought by the SME) and an 80% chance that the SME will be awarded CU100,000 (the amount that was recently awarded by the same judge in a similar case). Other outcomes are unlikely.

A 7% risk adjustment factor to the probability-weighted expected cash flows is considered appropriate to reflect the uncertainties in the cash flow estimates.

An appropriate discount rate is 10% per year.

At 31 December 20X1 the SME:

- (a) recognises an asset measured at CU100,000.
- (b) recognises an asset measured at CU84,000.
- (c) recognises a contingent asset measured at CU81,709.
- (d) discloses a contingent asset (and does not recognise an asset in its statement of financial position).

Answers

- Q1 (a)—See paragraph 21.1.
- Q2 (d)—See paragraph 21.4.
- Q3 (a)—See paragraph 21.7(a).
- Q4 (c)—See paragraph 21.7(b).
- Q5 (c)—See paragraph 21.1A.
- Q6 (d)—Calculation—CU28,000 (70% chance that outcome will occur × 20% × CU200,000) + CU56,000 (70% chance that outcome will occur × 80% × CU100,000) = CU84,000 expected value.
CU84,000 × 1.07 risk adjustment = CU89,880.
CU89,880 ÷ 1.1 discount factor = CU81,709.
- Q7 (b)—See paragraph 21.17.
- Q8 (d)—See paragraph 21.15.
- Q9 (b)—The court order is an adjusting event (see paragraph 32.5(a)) and the change in provision is accounted for as a change in accounting estimate (see paragraphs 21.11 and 10.16).
- Q10 (d)—See paragraph 21.16.

APPLY YOUR KNOWLEDGE

You can apply your knowledge of the requirements in Section 21 by completing the case studies provided.

Once you have completed a case study, check your answers against those on pages 58 and 61.

Case study 1

SME A gives warranties at the time of sale to its customers. Under the terms of the contract for sale SME A undertakes to make good, by repair or replacement, manufacturing defects that become apparent within one year from the date of sale. Based on experience, it is probable (more likely than not) that there will be some claims under the warranties.

At 31 December 20X1 SME A appropriately recognised a CU50,000 warranty provision.

SME A incurred and charged CU140,000 against the warranty provision in 20X2. CU80,000 of this charge is related to warranties for sales made in 20X2. The increase during 20X2 in the discounted amount recognised as a provision at 31 December 20X1 arising from the passage of time is CU2,000.

At 31 December 20X2 SME A estimated that it would incur expenditures in 20X3 to meet its warranty obligations at 31 December 20X2 as follows:

- 5% probability of CU400,000;
- 20% probability of CU200,000;
- 50% probability of CU80,000; and
- 25% probability of CU20,000.

Assume for simplicity that the 20X3 cash flows for warranty repairs and replacements take place on 30 June 20X3.

An appropriate discount rate is 10% per year. An appropriate risk adjustment factor to reflect the uncertainties in the cash flow estimates is an increment of 6% to the probability-weighted expected cash flows.

SME A is also the defendant in a lawsuit for breach of patent. SME A's lawyers believe that there is a 70% chance that SME A will successfully defend the case. However, if the court rules in favour of the claimant, the lawyers believe that there is a 60% chance that the entity will be required to pay damages of CU2 million (the amount sought by the claimant) and a 40% chance that the entity will be required to pay damages of CU1 million (the amount that was recently awarded by the same judge in a similar case). Other amounts of damages are unlikely.

The court is expected to rule in late December 20X3. There is no indication that the claimant will settle out of court.

A 7% risk adjustment factor to the cash flows is considered appropriate to reflect the uncertainties in the cash flow estimates.

An appropriate discount rate is 10% per year.

Prepare the journal entries to recognise the provision in the accounting records of SME A for the year ended 31 December 20X2.

Answer to Case study 1

In 20X2

Dr	Profit or loss (finance cost)	CU2,000	
	Cr	Provision (warranties)	CU2,000

To recognise the unwinding of the discount in 20X2 on the warranty provision recognised at 31 December 20X1.

Dr	Provision (warranties)	CU52,000 ^(a)	
Dr	Profit or loss (warranties for 20X1 sales)	CU8,000 ^(b)	
Dr	Profit or loss (warranties for 20X2 sales)	CU80,000	
	Cr	Cash	CU140,000

To recognise expenditure on warranties in 20X2.

At 31 December 20X2

Dr	Profit or loss (warranties)	CU106,000 ^(c)	
	Cr	Provision (warranties)	CU106,000

To recognise the warranty provision at 31 December 20X2.

The calculations and explanatory notes below do not form part of the answer to this case study.

- (a) Balance at 31 December 20X1 of CU50,000 plus the increase in that amount due to the passage of time of CU2,000 = CU52,000.
- (b) An additional profit or loss charge relating to 20X1 warranties because the provision made was CU52,000, but the actual amount incurred and charged relating to 20X1 warranties was CU60,000 (total amount charged in the year minus that relating to warranties for 20X2 sales = CU140,000 – CU80,000 = CU60,000; CU60,000 – CU52,000 = CU8,000).
- (c) Carrying amount of the warranties provision at 31 December 20X2:

<i>Probability-weighted expected cash flows</i>	<i>Including 6% risk adjustment</i>	<i>Discount rate</i>	<i>Discount factor</i>	<i>Present value</i>
CU105,000 ^(d)	CU111,300	10% per year	0.95238 (at 5% for 6 months)	CU106,000

(d) Probability-weighted expected cash flows:

CU400,000 × 5%	=	CU20,000
CU200,000 × 20%	=	CU40,000
CU80,000 × 50%	=	CU40,000
CU20,000 × 25%	=	CU5,000
Total		CU105,000

Note: Taking account of all of the available evidence, it is probable that SME A will successfully defend the court case. Therefore, SME A has a possible obligation and hence a contingent liability. SME A makes no journal entries for the court case it is defending—no amounts are recognised for contingent liabilities (see paragraph 21.12). However, it makes the disclosure in paragraph 21.15.

Case study 2

The facts are the same as those in Case study 1.

Draft an extract showing how SME A could present and disclose its provisions and contingent liabilities in its financial statements.

Answer to Case study 2

Extract from SME A's consolidated statement of financial position at 31 December 20X2:

Note 1 Accounting policies

Provisions

A provision is recognised when the entity has a present obligation at the reporting date as a result of a past event, it is probable that the entity will be required to transfer economic benefits in settlement and the amount of the obligation can be estimated reliably. A provision is measured 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. It is determined using probability-weighted expected cash flows adjusted to reflect the uncertainties in the cash flow estimates and discounted to reflect the time value of money. The discount rate is a pre-tax risk-free rate based on the rate for government bonds with the same term as the expected cash outflows.

Note 20 Provisions

A provision is recognised for expected claims on products sold with a one-year warranty. The entity undertakes to make good, by repair or replacement, manufacturing defects that become apparent within one year from the date of sale. The carrying amount of the warranty provision is estimated at the end of the financial reporting period using probability-weighted expected values based on experience, taking into account any circumstances that have affected product quality.

The provision for warranties is analysed as follows:

<i>Description</i>	<i>Warranties</i>
	<i>CU</i>
Carrying amount at 31 December 20X1	50,000
Unwinding of the discount	2,000
Additions relating to previous period	8,000
Additions relating to current period	186,000
Settled in the period	(140,000)
Unused amounts reversed	—
Carrying amount at 31 December 20X2	<u>106,000</u>
Analysed as follows:	
Current	106,000
Non current	—
	<u><u>106,000</u></u>

Note 21 Contingent liabilities

In 20X2 legal proceedings were instigated against SME A for breach of patent. The claimant is seeking CU2 million compensation for the alleged breach. Management has sought legal advice in this matter and believes the claim does not have merit. SME A's lawyers are confident that the court will rule in favour of SME A and that no amount of damages will be awarded to the claimant.

No amount is recognised in the financial statements for this possible liability, the existence of which is dependent upon the outcome of the legal proceedings.

NOTES



IFRS[®]

Foundation

Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD, UK

Tel **+44 (0) 20 7246 6410**

Email **customerservices@ifrs.org**

ifrs.org

The IFRS Foundation has trade marks registered around the world, including 'FSA[®]', 'IASB[®]', 'IFRS[®]', 'International Financial Reporting Standards[®]', 'ISSB[®]', and 'SASB[®]'. For a full list of our registered trade marks, visit www.ifrs.org.