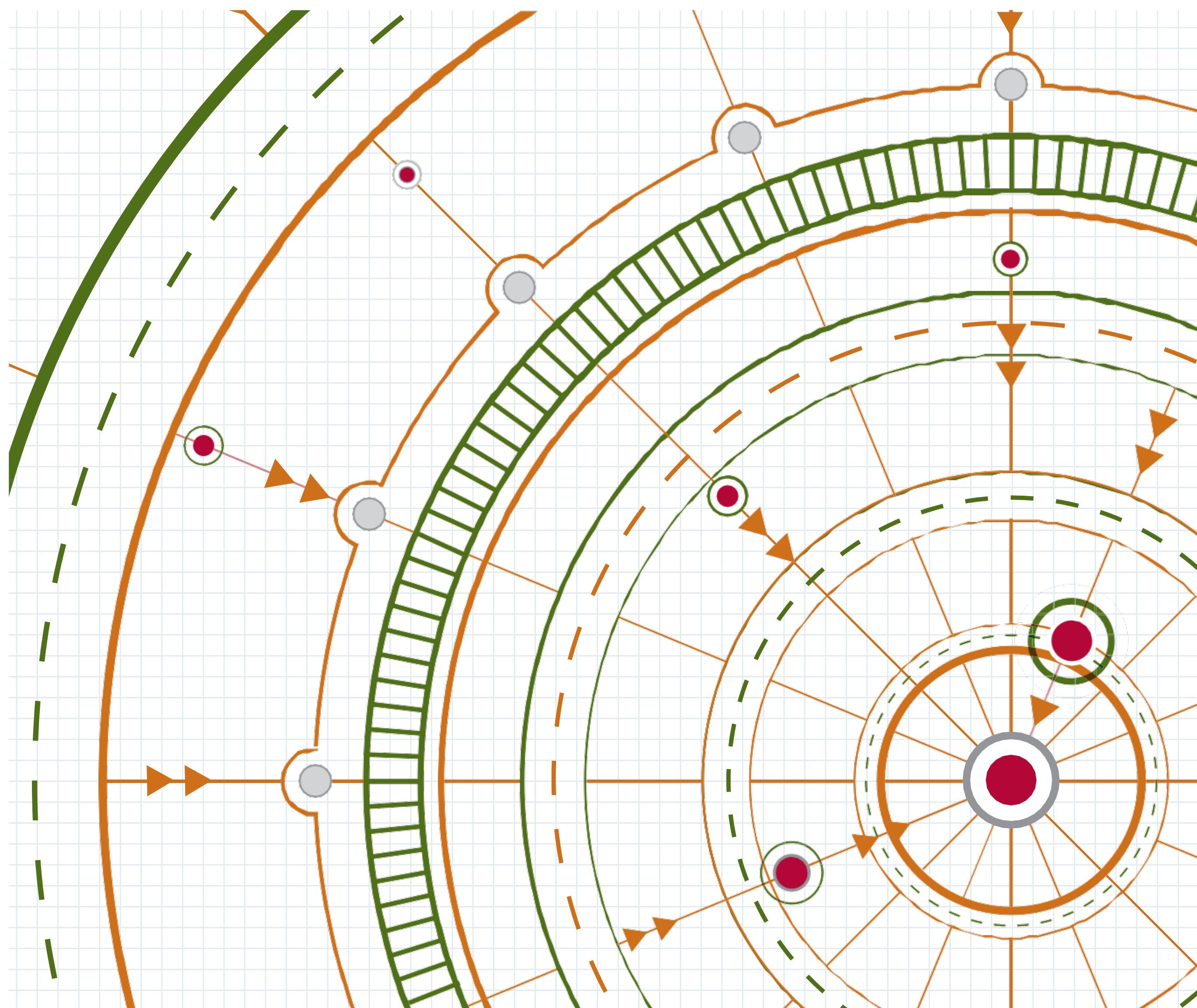
IFRS for SMEs® Standard (2015) + Q&As

IFRS® Foundation—Supporting Material for the *IFRS for SMEs* Standard

Module 21—Provisions and Contingencies



IFRS®

IFRS® Foundation Supporting Material for the *IFRS for SMEs*® Standard

including the full text of
Section 21 *Provisions and Contingencies*
of the *IFRS for SMEs* Standard
issued by the International Accounting Standards Board in October 2015

with extensive explanations, self-assessment questions and case studies

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Contents

INTRODUCTION 1
Which version of the *IFRS for SMEs* Standard? 1
This module 1
IFRS for SMEs Standard 2
Introduction to the requirements 3
What has changed since the 2009 *IFRS for SMEs* Standard 4
REQUIREMENTS AND EXAMPLES 5
Scope of this section 5
Initial recognition 10
Initial measurement 14
Subsequent measurement 20
Contingent liabilities 27
Contingent assets 28
Disclosures 29
Appendix—Guidance on recognising and measuring provisions 34
SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS 39
Initial recognition 39
Measurement 40
Disclosure 41
COMPARISON WITH FULL IFRS STANDARDS 42
TEST YOUR KNOWLEDGE 43
APPLY YOUR KNOWLEDGE 48
Case study 1 48
Answer to case study 1 49
Case study 2 50
Answer to case study 2 51

Module 21—Provisions and Contingencies

The accounting requirements applicable to small and medium-sized entities (SMEs) discussed in this module are set out in the *IFRS for SMEs* Standard, issued by the International Accounting Standards Board (Board) in October 2015.
This module has been prepared by IFRS Foundation education staff.
The contents of Section 21 *Provisions and Contingencies* of the *IFRS for SMEs* Standard are set out in this module and shaded grey. The Glossary of terms of the *IFRS for SMEs* 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. The notes and examples inserted by the education staff are not shaded. These notes and examples do not form part of the *IFRS for SMEs* Standard and have not been approved by the Board.

INTRODUCTION

Which version of the *IFRS for SMEs* Standard

When the *IFRS for SMEs* Standard was first issued in July 2009, the Board said it would undertake an initial comprehensive review of the Standard to assess entities' experience of the first two years of its application and to consider the need for any amendments. To this end, in June 2012, the Board issued a Request for Information: *Comprehensive Review of the IFRS for SMEs*. An Exposure Draft proposing amendments to the *IFRS for SMEs* Standard was subsequently published in 2013, and in May 2015 the Board issued *2015 Amendments to the International Financial Reporting Standards for Small and Medium-sized Entities (IFRS for SMEs* Standard*)*.

The document published in May 2015 only included amended text, but in October 2015, the Board issued a fully revised edition of the Standard, which incorporated additional minor editorial amendments as well as the substantive May 2015 revisions. This module is based on that version.

The *IFRS for SMEs* Standard issued in October 2015 is effective for annual periods beginning on or after 1 January 2017. Earlier application was permitted, but an entity that did so was required to disclose the fact.

Any reference in this module to the *IFRS for SMEs* Standard refers to the version issued in October 2015.

This module

This module focuses on the requirements for accounting and reporting of provisions and contingencies applying Section 21 *Provisions and Contingencies* of the *IFRS for SMEs* Standard. It introduces the subject and reproduces the official text along with explanatory notes and examples designed to enhance understanding of the requirements. The module identifies the significant judgements required in accounting for provisions, contingent liabilities and contingent assets. In addition, the module includes questions designed to test your understanding of the requirements and case studies that provide an opportunity to apply the requirements in accounting for provisions, contingent liabilities and contingent assets applying the *IFRS for SMEs* Standard.

Module 21—Provisions and Contingencies

Upon successful completion of this module, you should, within the context of the *IFRS for SMEs* Standard, be able to:

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

IFRS for SMEs Standard

The *IFRS for SMEs* Standard is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* Standard is comprised of mandatory requirements and other non-mandatory material.

The non-mandatory material includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* Standard and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a table of presentation and disclosure requirements;
- the Basis for Conclusions, which summarises the Board's main considerations in reaching its conclusions in the *IFRS for SMEs* Standard issued in 2009 and, separately, in the 2015 Amendments; and
- the dissenting opinion of a Board member who did not agree with the issue of the *IFRS for SMEs* Standard in 2009 and the dissenting opinion of a Board member who did not agree with the 2015 Amendments.

In the *IFRS for SMEs* Standard, the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* Standard, there are appendices to Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* These appendices provide non-mandatory guidance.

The *IFRS for SMEs* Standard has been issued in two parts: Part A contains the preface, all the mandatory material and the appendices to Section 21, Section 22 and Section 23; and Part B contains the remainder of the material mentioned above.

Further, the SME Implementation Group (SMEIG), which assists the Board with supporting implementation of the *IFRS for SMEs* Standard, publishes implementation guidance as 'questions and answers' (Q&As). These Q&As provide non-mandatory, timely guidance on specific accounting questions raised with the SMEIG by entities implementing the *IFRS for SMEs* Standard and other interested parties. At the time of issue of this module (January 2019) the SMEIG has not issued any Q&As relevant to this module.

Module 21—Provisions and Contingencies

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's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Such users include, for example, owners who are not involved in managing the business, existing and potential creditors and credit rating agencies.

The objective of Section 21 is to prescribe criteria for accounting for provisions, contingent liabilities and contingent assets, and to require disclosures in the notes to financial statements to enable users to understand their nature, timing and amount.

Provisions are a subset of liabilities. The *IFRS for SMEs* Standard 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. A provision is a liability of uncertain timing or amount. Examples of provisions include liabilities for warranties, lawsuits, customer refunds, onerous (loss-making) contracts, and plant closures and restructurings.

A provision is recognised only when a past event has created a present obligation, an outflow of resources is probable, and the amount of the obligation can be estimated reliably. Provisions are measured at the best estimate of the amount required to settle the obligation at the reporting date, and specified disclosures shall be given (see decision tree next page).

An accrual that is allowed for local income tax or other regulatory purposes is not necessarily the same as an expense or liability to be recognised for financial reporting purposes.

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 embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

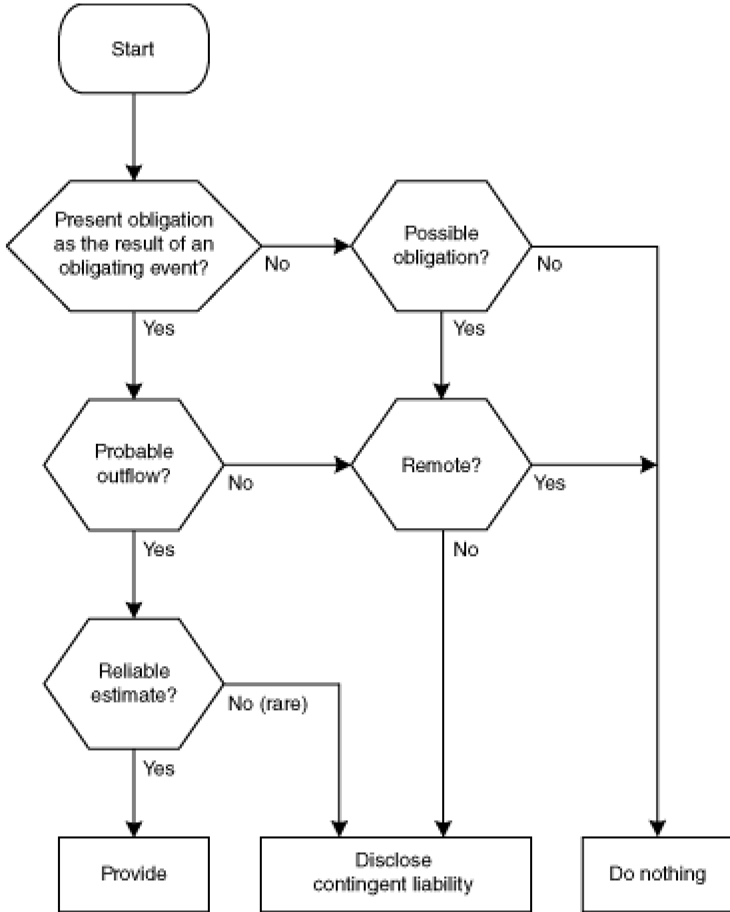
Except for contingent liabilities of an acquiree in a business combination (see paragraph 21.12) contingent liabilities are not recognised in the statement of financial position. However, in specified circumstances, they are disclosed in the notes (see decision tree next page).

In other words, this section classifies obligations of uncertain timing or amount into two categories—provisions and contingent liabilities. Those that meet the liability recognition criteria are classified as provisions. Those that do not meet the recognition criteria are classified as contingent liabilities. Contingent liabilities also include possible obligations. Possible obligations do not meet the definition of a liability. The classification of obligations is important because provisions are recognised in the entity's statement of financial position whereas contingent liabilities are not recognised.

The decision tree from the implementing guidance of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is reproduced as follows:

Module 21—Provisions and Contingencies

DECISION TREE



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 are not recognised in the statement of financial position. However, in specified circumstances, disclosure of a contingent asset is required (see paragraph 21.13).

In extremely rare cases, disclosure of some or all of the information required about provisions, contingent liabilities and contingent assets can be expected to prejudice seriously the position of the entity in a dispute. In such cases, an entity is permitted to make specified alternative disclosures. However, no relief is provided from the recognition and measurement requirements for provisions; an entity is required to recognise a provision and measure it at the best estimate of the amount required to settle the obligation at the reporting date.

Other requirements apply to the recognition and measurement of contingent liabilities of an acquiree in a business combination (see paragraph 21.12).

What has changed since the 2009 *IFRS for SMEs* Standard?

There were no significant changes made to Section 21 of the *IFRS for SMEs* Standard except for consequential changes made to paragraph 21.16 relating to the addition of clarifying guidance on the undue cost or effort exemption in Section 2 *Concepts and Pervasive Principles*.

Module 21—Provisions and Contingencies

REQUIREMENTS AND EXAMPLES

Scope of this section

21.1 This section applies to all **provisions** (ie **liabilities** of uncertain timing or amount), **contingent liabilities** and **contingent assets** except those provisions covered by other sections of this Standard. These include provisions relating to:

(a) **leases** (Section 20 *Leases*). However, this section deals with **operating leases** that have become onerous.

(b) **construction contracts** (Section 23 *Revenue*). However this section deals with construction contracts that have become onerous.

(c) **employee benefit** obligations (Section 28 *Employee Benefits*).

(d) **income tax** (Section 29 *Income Tax*).

Notes

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 *Basic Financial Instruments*).

Section 19 *Business Combinations and Goodwill* addresses the treatment by an acquirer of contingent liabilities assumed in a business combination.

The Glossary to the *IFRS for SMEs* Standard 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.' Provisions are a subset of liabilities. They are 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 (they may also relate to amounts due to employees). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Paragraph 2.20 of the *IFRS for SMEs* Standard specifies that an 'essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way. The obligation 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.

In some jurisdictions, it has been a practice under local GAAP to recognise a liability called 'general reserves' for unspecified potential or future losses based on a notion of conservatism or prudence. These reserves are sometimes referred to as provisions but they do not meet the definition of a provision or a liability in the *IFRS for SMEs* Standard. Therefore, recognition as liabilities of such 'general reserves' is prohibited.

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, and as illustrated in paragraph 21A.1 of the Appendix to Section 21,[1] it is inappropriate to recognise a provision for an entity's expected future losses, because the entity has no present obligation to incur those losses (the entity could, for instance, cease the operations that would generate the future losses). It is important to bear in mind, however, 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*. Also, 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—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).

Examples—provisions

Ex 1 **Waste from an entity's production process contaminated the groundwater at the entity's plant. In a lawsuit brought against the entity, members of the local community seek compensation for damages to their health as a result of the contamination. The entity acknowledges its wrongdoing and the court is deciding on the extent of the compensation to be awarded to the members of the local community. It is uncertain when the ruling will take place but the entity's lawyers expect 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.**[2]

The entity has a liability of uncertain timing or amount (a provision). At the end of the reporting period, the entity 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 entity's production process contaminated the groundwater at the entity's plant. In this example there is no court case. However, the entity is required by law to restore the contaminated environment.**

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

The entity 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.

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[1] 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.

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

Ex 3 **A manufacturer gives warranties to the purchasers of its goods. Under the terms of the warranty, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale to the purchasers.**

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

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

The entity'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 entity has a legal obligation to make good the defective goods sold to its customers. The obligation is of uncertain timing or amount.

Category 2—defective goods held on 31 December 20X0

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

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 manufactured in 20X1

At 31 December 20X0 the entity 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 entity 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 *Events after the End of the Reporting Period*).

Examples—not provisions

Ex 4 **An entity that operates and owns ten petrol stations (along with the land on which they are built) chooses not to purchase fire insurance for those buildings but, rather, to self-insure against fire loss. The entity can estimate reliably the statistical probability of the occurrence and amount of expected fire loss (about CU100,000 once every ten years). The entity wants to recognise a provision of CU10,000 and related expense each year for the next ten years to reflect its expected loss. The entity argues that the loss is highly probable, the amount can be measured reliably, and if it had purchased insurance it would recognise an expense in each reporting period.**

The fact that the entity has retained the risk of fire does not create an obligation that is recognised as a provision. An entity that purchases insurance has paid to transfer its risk to a third party, and that payment is properly 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 over the period in which the insurance coverage is consumed, whether or not 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 in a cyclical business. Its earnings fluctuate from one year to the next depending primarily on the weather. The management and owners of the entity believe that, because of this volatility, it is prudent to defer recognition of a portion of the profit in a good year to the inevitable bad year by recognising a provision in good years and reversing the provision in bad years. Also, the local income tax law allows deferral of a portion of the profit in a good year to help ensure that ski-resort operators have sufficient cash to continue operating in bad years. The entity'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 entity does not have an obligation to another party in expectation of a bad year. It is not appropriate to recognise a provision under the *IFRS for SMEs* Standard because there is no liability.

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 *Income Taxes*).

Ex 6 **An entity operates an opencast mine in a jurisdiction where 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 would leave the relevant mining company liable to a substantial fine.**

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

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

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

At 31 December 20X1 the entity has sunk a shaft five metres deep. It is highly likely that the entity 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 entity may conclude that:

- it does not have a present obligation because the shaft is less 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; or
- a present obligation exists because the entity has no realistic alternative to digging to more than 10 metres and hence 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 entity has sunk a shaft 12 metres deep.

At 31 December 20X2 a present obligation exists because the entity 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).

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 performed any of its obligations or both parties have partially performed their obligations to an equal extent.

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 for 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.

In the case of a lease of an asset that 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 landlord would accept to terminate the lease (or, in the words of 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 to other contracts.

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.

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.

Notes

A provision is a present obligation to act or perform in a particular way (see paragraph 2.20) but the costs or the required action are of uncertain timing or amount. Throughout this module, the recognition criteria in paragraph 21.4(a), specifically the phrase 'obligation at the reporting date' is read as synonymous with 'present 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.

Where no reliable estimate can be made, a liability exists that is not recognised. That liability is disclosed as a contingent liability (see paragraph 21.12).

Examples—initial recognition of provision

Ex 7 **A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract, 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 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 entity 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 in which the entity sold the products with warranties to its customers.

Note: The notes to 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 entity obligated for any outflow of resources. Warranties are different. There is a past event that obligates the entity to make repairs or replacements—the sale of products with a warranty.

Ex 8 **In 20X5 a lawsuit was brought against an entity 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 entity's production process. It is uncertain whether the entity 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. Furthermore, the entity denies any wrongdoing because it has taken precautions to avoid such leaks; and so it is defending the case. However, the entity cannot be certain that it has not caused the contamination and the source of the contamination will become known only after extensive testing. The entity's lawyers expect a court ruling in approximately two years. Up to the date of approval (authorisation) of the financial statements for the year ended 31 December 20X5, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares its financial statements for the year ended 31 December 20X6, the entity has been found liable, and its lawyers advise that it is probable that the entity will be required to pay compensation.**

At 31 December 20X5 on the basis of the evidence available when the financial statements were approved, there is a possible but uncertain obligation. The uncertainty is sufficiently high 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 regarded as remote.

At 31 December 20X6 there is a present obligation and on the basis of 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. Information about the lawsuit is disclosed in the financial statements.

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 entity constructed an item of equipment for use in its manufacturing operations. The entity 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* rather than included in profit or loss in the period of construction. The effect of so doing 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, paragraph 21.7 provides that 'the amount of a provision shall be the present value of the amount expected to be required to settle the obligation'; and by paragraph 21.11 the subsequent unwinding of the discount is required to be recognised as finance cost in profit or loss. The finance cost is not an addition to the capitalised cost of the equipment.

Ex 10 **Effluent released from an entity's manufacturing process contaminates the land on which the entity operates. At the end of the plant's useful life, the entity 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 entity 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.

Notes

Paragraph 2.20 specifies that an essential characteristic of a liability is that 'the entity has a present obligation to act or perform in a particular way'. The paragraph goes on to provide that the obligation 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 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.'

As illustrated in paragraph 21A.3 in the Appendix to Section 21, in the case of restructuring, it requires more than management's intention for a present obligation to exist (and for a provision to be accrued). Intentions can change, and they are not past events that obligate 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 where a public announcement by an entity indicated to other parties that it will accept certain responsibilities and, as a result, the entity created 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 as at reporting date affects recognition of a provision.

Examples—obligating event

Ex 11 **An entity has made a written pledge to contribute a substantial sum of money toward the construction of a new performing arts centre in its community. Executives of the entity appeared at a press conference to announce the pledge. With the entity's consent, the charitable organisation that is building the arts centre has cited the entity's pledge in its materials soliciting additional pledges for construction. Under local law, pledges to charitable organisations are not legally enforceable.**

Although the pledge may not be legally enforceable, by participating in the press conference and by allowing its name to be used in the solicitation, the entity 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 entity recognises a provision.

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

The entity has issued a press release to the public that it will accept responsibility to restore the contaminated environment and has as a result 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 entity 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 entity has a liability of uncertain timing or amount (ie a provision).

An example about refunds policy is also set out in paragraph 21A.5 in the Appendix to Section 21.

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.

Notes

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. 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 very expensive 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 also be the cost of performing an obliged action (ie doing a clean-up work) and not necessarily always is a payment.

An entity applies judgement in measuring the estimated settlement amount. The judgement should reflect experience from similar transactions and also consider any evidence of conditions that existed at the reporting date provided by events after the reporting date but before the financial statements are authorised for issue.
Section 32 *Events after the End of the Reporting Period* 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 that may affect the amount required to settle an obligation (eg 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 sufficient objective evidence that those future events will occur. Therefore, an entity would not, for example, anticipate the development of a completely new technology.

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. However, in other cases it may be clear that adjusting for the time value of money would not have a material impact on the financial statements. This may be so, for example, if the time period until settlement is short or the provision (and the related finance cost if discounted) is small relative to other items in the financial statements. As materiality is a matter of judgement, it is important to assess materiality in relation to both the statement of financial position and the statement of comprehensive income (see paragraph 2.6 of Section 2 *Concepts and Pervasive Principles*).

Provisions are measured before tax. The tax consequences of the provision, 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*.

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 (or 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 result in double counting them.

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 in the bond) if available. The yield on a government bond issued in the jurisdiction with the same currency and maturity date that approximates to the timing of the expected cash flow is often considered to be indicative of the risk-free rate for that cash flow. In the absence of government bonds in an entity's jurisdiction, 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 within 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 to comply with the requirements of paragraph 21.7: '[t]he 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.' In many cases, an entity may find it less difficult and complicated to reflect risks specific to the liability in the estimation of cash outflows rather than adjusting the pre-tax risk-free discount rate.

Examples—initial measurement

Ex 13 **An entity's production process causes contamination to the land on which the entity's plant is built. The entity is required by law to restore the environment at the end of its plant's useful life of 10 years. The entity estimates clean-up costs varying between CU200,000 and CU275,000.**

After weighing the probabilities of the various clean-up cost scenarios, the expected cash outflows are estimated to be CU231,250. The entity increases these by 5%, which in total is the amount it estimates a third party would charge to compensate it for the uncertainties. It discounts the risk-adjusted cash flows by the risk-free rate, say 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 = CU242,813 ÷ 1.06^{10} discount factor).

Ex 14 **An entity sells 1,000 units of a product with warranties under which the entity will repair any manufacturing defects that become apparent within the first six months after purchase. If a minor defect is detected in a product, estimated repair costs of CU100 will be incurred. If a major defect is detected in a product, estimated repair costs of CU400 will be incurred. The entity's experience adjusted to reflect changes in product design and manufacturing indicate 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), when the provision involves a large population of items, the best estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities.

The expected value of the cost of repairs is: (75% × 1,000 units sold × nil) + (20% × 1,000 units × CU100) + (5% × 1,000 units × CU400) = 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 entity. The customer alleges that he suffered personal injury as a result of using one of the entity's products. The entity's lawyers estimate that the entity will be found responsible and that at the reporting date (31 December 20X1) the entity will likely be ordered to pay compensation of CU300,000.**

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

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

Calculations:

[a] Risk-adjusted present value: CU300,000 × (1/1.04) × (1/1.04) = CU277,367.

Ex 16 **The facts are the same as in Example 15. However, in this example, the lawyers estimate that the entity will be found responsible and that the entity 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. On the basis of the facts above, the individual most likely outcome is that compensation of CU300,000 will be paid. Because the other possible outcomes are neither mostly higher nor mostly lower than the most likely outcome, a provision of CU300,000 is appropriate.

Ex 17 **The facts are the same as in Example 15. However, in this example, the lawyers estimate that the entity has a 60% chance of winning the lawsuit and thereby avoiding the payment of compensation. Furthermore, the entity's lawyers estimate that the entity has a 20% chance of being found responsible and ordered to pay the customer 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 entity 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. This is because it is not probable (ie more likely than not) that an outflow of economic benefits will be required. However, the entity does have a contingent liability and the requirements of paragraph 21.7 are relevant to estimating the financial effect of the contingent liability that the entity would 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 entity has a 25% chance of winning the lawsuit and thereby avoiding the payment of compensation. Furthermore, the entity's lawyers, having reviewed a number of similar cases, estimate that the entity 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 and it would be appropriate to measure the amount on an expected value basis. Doing so, the entity will recognise a provision at 31 December 20X1 of approximately CU705,000 (its expected value).[3]

Calculation:

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

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.

Notes

Sometimes, an entity is able to 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 so that the entity 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 costs 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.

[3] The individual most likely outcome is CU300,000. Because other possible outcomes are mostly higher than CU300,000 in expectation, the best estimate will be different than the most likely outcome. To make the adjustment, this entity 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.

Examples—reimbursements

Ex 19 **A retailer gives warranties at the time of sale to purchasers of the products it sells. 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 purchaser) that become apparent within three years from the date of sale. On the basis of 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 warranted 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 (see below).

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 purchasers, 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 purchasers. The amount to be recognised by the retailer for the reimbursement asset relating to goods sold to the purchasers is not necessarily the same amount as the retailer 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.

Ex 20 **A manufacturer sells products to a retailer. The retailer sells those products to customers.**

Any products that are unsold by the retailer after a six-month period can be returned to the manufacturer, except for those products that have been damaged while in the possession of the retailer. The terms of the sale-or-return agreement are such that the manufacturer recognises revenue only when the retailer sells the products to customers.

The manufacturer gives warranties directly to the 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 to the customers. The customers are informed that the warranty contract is with the manufacturer when purchasing the products. Customers must send any defective products direct to the manufacturer for repair or replacement. On the basis of experience, it is probable that there will be some valid claims under the warranties.

The retailer has no rights and no obligations relating to the warranties provided to the customers by the manufacturer. The retailer is not party to the warranties and does not recognise a warranty provision in its financial statements. If products are damaged while in the possession of the retailer, then an impairment expense would be recognised by the retailer for those products.

The manufacturer recognises the best estimate of the amount required to settle the warranty obligation (see paragraph 21.7(a)) as a provision on the date when the retailer sells the products to the customers.

Ex 21 **The facts are the same as in Example 20. However, in this example, products that are unsold by the retailer cannot be returned to the manufacturer.**

The retailer has no rights and no obligations relating to the warranties provided to the customers by the manufacturer. The retailer is not party to the warranties and does not recognise a warranty provision in its financial statements. If products are damaged while in the possession of the retailer or if products cannot be sold, then an impairment expense would be recognised for those products.

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

Subsequent measurement

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

Notes

As noted in page 14, estimation is an essential part of financial reporting. Unless the difference is due to an error in prior period (see paragraph 10.19 of Section 10 *Accounting Policies, Estimates and Errors*) this change is a revision of estimate (see paragraphs 10.15–10.17.

When the provision is actually 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.

Examples—expenditures charged against a provision

Ex 22 **An entity recognised a CU40,000 provision for a lawsuit at 31 December 20X1. In March 20X2 the case was dismissed without the right to appeal. In April 20X2 the entity undertook an advertising campaign costing CU40,000. The entity made the following entry in its accounting records to recognise the advertising campaign:**

April 20X2

Dr	Provision for lawsuit (liability)	CU40,000	
	Cr Cash		CU40,000

To set off the cost of the advertising campaign against the provision for the lawsuit.

The above journal entry is incorrect. The entity should not charge the cost of its advertising campaign against the provision for a lawsuit because it is not an expenditure for which the provision was originally recognised.

The entity should have accounted for the events as follows:

March 20X2

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

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

April 20X2

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

To recognise the cost of the advertising campaign.

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 23 **During 20X1 an entity was sued for environmental damage (Case A). At 31 December 20X1 the entity 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 entity. Later that month, the court ruled against the entity in Case B. In accordance with the verdict, the entity was ordered to pay the plaintiff damages of CU40,000.

In 20X2 the entity made the following 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 set off the reversal of the provision for Case A against the liability for Case B.

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

The entity should have accounted for the events as follows:

September 20X2

Dr	Provision for lawsuit (liability)	CU50,000[(a)]	
	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 entity 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 24 **At 31 December 20X1 an entity recognised a CU400,000 provision for an announced restructuring of its operations.**

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

The entity 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 entity 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 entity 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 below 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 (which will mean 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.

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 change is made to the recognised amount of an existing provision, or a new provision is recognised, because of a prior period error (see paragraph 10.19), 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 in the amounts recognised in its financial statements that provide evidence of conditions that existed at the end of the reporting period that occur prior to the date that financial statements are authorised for issue (adjusting events after the end of the reporting period); see Section 32 *Events after the End of the Reporting Period*.

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 25 **An entity 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 because the lawsuit is one year closer to settlement. CU3,000 of the increase is attributable to the unwinding of the discount and the remainder of the increase is the result of better information becoming available during 20X2 on which to base the estimates.**

At 31 December 20X2 the entity recognises a provision of CU90,000. The increase of CU50,000 will be recognised as an expense in the determination of the entity'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.

Ex 26 **An entity operates a chemical-manufacturing plant and is required by its licensing agreement to decommission the plant at the end of its useful life. The obligation to decommission arose from the construction of the plant. The plant is accounted for by applying Section 17 *Property, Plant and Equipment*.**

In its statement of financial position as at 31 December 20X1, the entity reported a provision for decommissioning its chemical manufacturing plant of CU400,000.

At 31 December 20X2 the best estimate of the amount required to settle the decommissioning obligation is CU600,000. CU28,000 of the increase in the provision is attributable to the unwinding of the discount; the remainder of the increase is attributed to better information becoming available during 20X2 on which to base the estimate.

At 31 December 20X2 the entity recognises a provision of CU600,000. The part of the increase that arises from the unwinding of the discount (CU28,000) is a finance cost that is recognised as an expense in the determination of the entity's profit or loss for the year ended 31 December 20X2. The part of the increase that is attributed to better information becoming available on which to base the estimates (CU172,000) is added to the cost of the asset (the item of plant). The adjusted depreciable amount of the asset is depreciated over its remaining useful life. Depreciation is recognised as an expense by applying Section 17.

Because the adjustment results in an increase in the cost of the asset, the entity considers whether such an increase is an impairment indicator; there may be a chance that the carrying amount exceeds the recoverable amount (see Section 27 *Impairment of Assets*).

Ex 27 **An entity provides warranties to purchasers of its products. When preparing its 31 December 20X5 financial statements, the entity initially estimated its warranty obligation for products sold before 31 December 20X5 at CU100,000. Before the 31 December 20X5 annual financial statements were approved for issue, a customer discovered a latent defect in one of the products purchased from the entity before 31 December 20X5 and reports the defect to the entity. As a result of the discovery, the entity revised its estimate of its warranty obligation at 31 December 20X5 to CU150,000.**

At 31 December 20X5 the obligation for the warranty provision is measured at CU150,000. This is the determination of an accounting estimate, not a change in accounting estimate. The latent defect is a condition that existed at end of the reporting period and is therefore reflected in estimating the amount of the obligation at the end of the reporting period even though the information was discovered later (see Section 32 *Events after the End of the Reporting Period*, particularly paragraphs 32.2–32.5).

Ex 28 **The facts are the same as in Example 27. However, in this example, the latent defect was discovered after the 31 December 20X5 annual financial statements were approved for issue. In July 20X6 the entity paid CU150,000 to transfer the obligation to an independent third party.**

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

The additional CU50,000 obligation (not included in the provision for at 31 December 20X5) is a change in accounting estimate for the year ended 31 December 20X6. The warranty obligation (provision) was appropriately measured and reported at CU100,000 in the entity's 31 December 20X5 annual financial statements. This estimate needs to be revised in 20X6 because the discovery of the latent defect was made after the 20X5 financial statements were approved for issue. The CU50,000 is recognised as an expense in determining profit or loss for the six-month period ended 30 June 20X6 (see paragraph 10.16).

Ex 29 **The facts are the same as in Example 4 of Appendix to Section 21[4].**

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 present value at the end of 20X0 is calculated as:

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
	46,000			41,846

[4] Example 4 Warranties

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
	18,400			17,037

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
	41,846		2,669

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 calculated above.

Example 34 illustrates the reconciliation of the opening and closing balances that would be disclosed for this fact pattern.

Module 21—Provisions and Contingencies

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 provisions for contingent liabilities of an acquiree in a **business combination** (see paragraphs 19.20 and 19.21). 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.

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, ie 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.

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.	*if there is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.*	*if there is a possible obligation or a present obligation for which the likelihood of an outflow of resources is remote.*
A provision is recognised (paragraph 21.4).	No provision is recognised (paragraph 21.12).	No provision is recognised (paragraph 21.12).
Disclosures are required for the provision (paragraph 21.14).	Disclosures are required for the contingent liability (paragraph 21.15).	No disclosure is required (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 that is a liability that is not recognised because it cannot be measured reliably. Disclosures are required for the contingent liability (paragraph 21.15).

Example—contingent liabilities

Ex 30 **The facts are the same as in Example 8.**

On the basis of the facts it may be uncertain whether the entity has a present obligation—this is the matter being determined by the court. 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.

The entity has a possible obligation if, considering all of the available evidence, it is probable that the entity will successfully defend the court case. In such circumstances, the entity is deemed not to have a present obligation; rather, it has only a contingent liability.

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

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, as set out in the table below, 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.	*if the inflow of economic benefits is probable, but not virtually certain.*	*if the inflow is not probable.*
The asset is recognised, it is not contingent (see paragraph 21.13).	No asset is recognised (see paragraph 21.13). Disclosures are required (see paragraph 21.16).	No asset is recognised (see paragraph 21.13). No disclosure is required (see paragraph 21.16).

Examples—contingent assets

Ex 31 **An entity 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 entity.**

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

The entity 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 32 **The facts are the same as in Example 31. However, in this example, it is virtually certain that the court will order the competitor to pay damages to the entity.**

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

Ex 33 **The facts are the same as in Example 31. However, in this example, it is probable that the court will rule in favour of the competitor (it is probable that the entity's case will not be successful).**

An asset should not be recognised. Because 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.

Example—disclosures about provisions

Ex 34 **The facts are the same as Example 29. In this example, the actual warranty payments equals those estimates. At end of 20X1 the reconciliation required by paragraph 21.14 is as follows:**

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

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 35 **An entity could present disclosures about its provisions as follows:**

Note 2 Accounting policies

Provisions

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 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.

Note 22 Provisions

	Warranties	*Decommissioning*	*Total*
	CU	*CU*	*CU*
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
	61,000	**35,000**	**96,000**

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 (ie 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 it is 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 decommission. 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 sufficient objective evidence 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.

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 36 **An entity could present disclosures about its contingent liabilities as follows:**

Note 30 Contingent liabilities

A customer has instigated legal proceedings against the entity, alleging personal injury resulting from use of the entity's products. The customer has claimed compensation of CU2 million. On the basis of 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 ruled in favour of the customer, the compensation awarded would probably be no higher 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.

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 37 **An entity could present disclosures about its contingent assets as follows:**

Note 31 Contingent assets

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

Entity A's lawyers believe that it is probable that Entity B will be found responsible and award Entity A 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.

Notes

In extremely rare cases, described in paragraph 21.17, an entity is permitted to make the specified alternative disclosures (which are set out in that paragraph). 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.

Appendix to Section 21

Guidance on recognising and measuring provisions

This Appendix accompanies, but is not part of, Section 21. It provides guidance for applying the requirements of Section 21 in 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 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.

Present obligation as a result of a past obligating event—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 a business concerned;
   (ii) the principal locations affected;
   (iii) the location, function and approximate number of employees who will be compensated for terminating their services;
   (iv) the expenditures that will be undertaken; and
   (v) when the plan will be implemented; and
(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.

Conclusion—an entity recognises a provision for restructuring costs only when it has a legal or constructive obligation at the reporting date to carry out the restructuring.

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 A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event—the obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund purchases.

An outflow of resources embodying economic benefits in settlement—probable that a proportion of goods will be returned for refund.

Conclusion—the entity recognises a provision for the best estimate of the amount required to settle the refunds.

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 at the reporting date.

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 at 31 December 20X2, 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* Standard to transactions and events often requires the exercise of judgement, including making estimates. Information about significant judgements made by an entity's management and key sources of estimation uncertainty are useful when assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements—apart from those involving estimates—that its management has made when applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, applying paragraph 8.7, an entity must disclose information about the key assumptions concerning 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 *IFRS for SMEs* Standard require disclosure of information about particular judgements and estimation uncertainties.

Initial recognition

In accordance with Section 21 *Provisions and Contingencies*, 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 (the exception is contingent liabilities of an acquiree in a business combination). 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 applied 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.

Examples of scenarios in which the exercise of significant judgement may be necessary to determine whether a present obligation exists include:

- when, in the absence of a legal obligation, an entity's actions—such as an established pattern of past practice, published policies or a sufficiently specific current statement—might have indicated to other parties that it will accept particular responsibilities, and has thereby created valid expectations in the other parties that the entity will discharge those responsibilities (ie determining whether a constructive obligation has been created).
- when a lawsuit is brought against an entity, seeking compensation for damages to third parties alleged to have been caused by the entity's production process. It is unknown whether the entity is the source of the damage, which can only be determined after extensive testing.

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)—ie 'more likely than not' or, in other words, more than a 50% probability—can be challenging in classifying those 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, and hence probable.

Scenarios in which the exercise of significant judgement may be necessary to determine whether an outflow of benefits will be required in respect of a present obligation include when, as a result of an entity's negligence, a third party has a legal right to claim compensation from the entity and, on the basis of the evidence available, there is approximately an equal chance of the third party making a claim or 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 can make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In some cases, significant judgement may be required to determine whether the obligation can be measured with sufficient reliability 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 page 14, the use of estimates is an essential part of the preparation of financial statements and does not in itself undermine their reliability.

Example—lawsuit

The effects of discounting have been ignored in this simplified example.

An entity is defending a lawsuit. On the basis of legal advice, management estimates that the entity has a 60% chance of being found liable and required to pay CU100 million and a 40% chance of not being held liable, with no payment being required.

CU100 million is the most likely outcome. One way of estimating the provision would be to use probability-weighted expected cash flows (CU60 million = 60% × 100 million + 40% × nil). Judgement is applied and the risk adjustment is estimated to be CU10 million. The maximum amount that a third party in the reporting entity's position would rationally pay to either the counterparty (to settle the obligation) or another third party (to transfer the obligation) is CU70 million.

There may be third parties that are willing to assume the obligation, and evidence that the amount such third parties would demand would be less than CU70 million. Perhaps this would be the case if third parties specialised in contesting this type of claim and were therefore more likely to achieve a favourable outcome.

If this were the case, the amount that the entity would rationally pay to settle the obligation might be less than CU70 million. Further judgements may be necessary if the counterparty might be prepared to settle out of court.

Example—warranties

Experience of the extent of defects in products subject to warranty is likely to be useful in estimating the amount required to settle the present obligation at the reporting date. Such experience should be more reliable when the product has been made using the same materials and processes over many years.

Measuring provisions for new products or products manufactured with new materials or processes involves increased uncertainties. In such cases, an entity might possess applicable experience from its introduction of earlier products or processes. That experience may be useful when estimating the defect levels in new products and new production processes implemented in a current reporting period.

In accordance with Section 32 *Events after the End of the Reporting Period*, information about a warranty obligation that existed at the reporting date is collected until the financial statements are authorised for issue.

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.

Module 21—Provisions and Contingencies

COMPARISON WITH FULL IFRS STANDARDS

When accounting for and reporting provisions, contingent liabilities and contingent assets for periods beginning on 1 January 2017, the main differences between the requirements of full IFRS Standards (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) and the *IFRS for SMEs* Standard (see Section 21 *Provisions and Contingencies*) are:

- The *IFRS for SMEs* Standard is drafted in simpler language than that used in full IFRS Standards;
- Includes significantly less guidance on how to apply the principles.

Module 21—Provisions and Contingencies

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting provisions, contingent liabilities and contingent assets applying the *IFRS for SMEs* Standard by answering the questions provided.

You should assume that all amounts mentioned are material.

Once you have completed the test, check your answers against those set out beneath it.

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 (eg 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) through (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 as the individual most likely outcome.

☐ (c) may be the individual most likely outcome. However, 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 as the individual most likely outcome.

☐ (c) the individual most likely outcome adjusted to take account of the effect of other possible outcomes.

Question 5

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 one year from the date of sale. On the basis of experience, it is probable (more likely than not) that there will be some claims under the warranties.

Sales of CU10 million were made evenly throughout 20X1.

At 31 December 20X1 the expenditures for warranty repairs and replacements for the product sold in 20X1 are expected to be made 50% in 20X1 and 50% in 20X2. Assume for simplicity that all the 20X2 outflows of economic benefits related to the warranty repairs and replacements take place on 30 June 20X2.

Experience indicates that 95% of products sold require no warranty repairs; 3% of products sold require minor repairs costing 10% of the sale price; and 2% of products sold require major repairs or replacement costing 90% of the sale price. The entity believes that future warranty claims will not be different from its experience.

At 31 December 20X1 the appropriate discount factor for cash flows expected to occur on 30 June 20X2 is 0.95238. Furthermore, 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.

At 31 December 20X1 the entity recognises a warranty provision measured at:

☐ (a) CU0.

☐ (b) CU210,000.

☐ (c) CU222,600.

☐ (d) CU111,300.

☐ (e) CU106,000.

Question 6

An entity is the defendant in a patent-infringement lawsuit. The entity'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 entity will be required to pay damages of CU200,000 (the amount sought by the claimant) and an 80% chance that the entity 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 entity 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 entity in the dispute over the alleged breach of patent.

At 31 December 20X1 the entity would:

☐ (a) not recognise a provision and disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.

☐ (b) recognise a provision measured at the amount determined in Question 6 and disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.

☐ (c) recognise a provision measured at the amount determined in Question 6 and 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 entity's lawyers believe there is a 60% chance that the court will dismiss the case and the entity 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 entity's 31 December 20X4 financial statements were authorised for issue, a court ordered the entity to pay CU120,000 damages in full and final settlement of a patent-infringement lawsuit brought against the entity 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 that the entity had expected to pay throughout the duration of the case based on precedents from similar cases and advice from their lawyers. The entity will not contest the judgement.

In its 31 December 20X3 annual financial statements, the entity 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 entity:

☐ (a) restates the comparative information as at 31 December 20X3 (retrospective restatement of a prior period error).

☐ (b) measures the provision as at 31 December 20X4 at CU120,000 (comparative information 20X3: CU20,000) (it is a change in accounting estimate in its 20X4 financial statements).

☐ (c) measures the provision as at 31 December 20X4 at CU20,000 (comparative information 20X3: CU20,000) and record the effect of the higher-than-expected settlement in profit or loss for the year ended 31 December 20X5 (account prospectively for the change in accounting estimate in the period that the final settlement amount was determined).

Question 10

At 31 December 20X1 an entity 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 entity's lawyers believe there is a 70% chance that the entity will win the case. Furthermore, they believe that there is a 20% chance that the entity will be awarded CU200,000 (the amount sought by the entity) and an 80% chance that the entity 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 entity:

☐ (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).

Module 21—Provisions and Contingencies

Answers

Q1 (a) reason—see paragraph 21.1.
Q2 (d) reason—see paragraph 21.4.
Q3 (a) reason—see paragraph 21.7(a).
Q4 (c) reason—see paragraph 21.7(b).
Q5 (e) calculation—CU30,000 (3% probability of minor repairs × 10% × CU10 million) + CU180,000 (2% probability of major repairs × 90% × CU10 million) = CU210,000 expected value. CU210,000 × 1.06 risk adjustment = CU222,600. CU222,600 × 50% to be settled in 20X2 = CU111,300. CU111,300 × 0.95238 discount factor for 6 months = CU106,000.
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) reason—see paragraph 21.17.
Q8 (d) reason—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) reason—see paragraph 21.16.

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting provisions, contingent assets and contingent liabilities applying the *IFRS for SMEs* Standard by completing the case studies provided.

Once you have completed the case studies check your answers against those set out beneath it.

Case study 1

SME A gives warranties at the time of sale to purchasers of its product. 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. On the basis of experience, it is probable (ie more likely than not) that there will be some claims under the warranties.

At 31 December 20X1 SME A appropriately recognised CU50,000 warranty provision. SME A incurred and charged CU140,000 against the warranty provision in 20X2. CU80,000 of this 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 average, 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. Its 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 accounting entries to record 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 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 less CU80,000 = CU60,000), CU60,000 minus CU52,000 = CU8,000.

(c) Carrying amount of the warranties provision at 31 December 20X2:

Probability-weighted expected cash flows	*Including 6% risk adjustment*	*Discount rate*	*Discount factor*	*Present Value*
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 itis defending—no amounts are recognised for contingent liabilities (see paragraph 21.12). However, disclosure is necessary (see 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:

Description	*Warranties (CU)*
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	106,000
Analysed as follows:	
Current	106,000
Non-current	–
	106,000

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.