INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS (IPSAS) WORKSHOP

IPSAS 19: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Hilton Hotel, Nairobi, 13th – 14th July, 2017

Session Content

- Definition of concepts/terms
- Recognition
- Measurement
- Disclosure

Introduction

- The Standard is drawn primarily from International Accounting Standard (IAS) 37 – provisions, contingent liabilities, and contingent assets.

- This Standard aim to
  (a) define provisions, contingent liabilities, and contingent assets, and
  (b) identify the circumstances in which provisions should be recognized, how they should be measured, and the disclosures that should be made about them.

- Effective Date:- Periods beginning on or after January 1, 2004

Objective and Scope

- To prescribe appropriate recognition criteria and measurement bases for provisions, contingent liabilities and contingent assets, and to ensure that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing, and amount.
- IPSAS 19 thus aims to ensure that only genuine obligations are dealt within the financial statements.
- Planned future expenditure, even where authorised by management, is excluded from recognition, as are accruals for self-insured losses, general uncertainties, and other events that have not yet taken place

Definitions

Liabilities - present obligations from a <u>past event</u> expected to result in an <u>outflow of resources</u>

Accruals - liabilities to pay for <u>goods or services received or supplied but not yet paid or invoiced</u>

Provisions - liabilities of <u>uncertain timing or amount</u>

Definitions

- A contingent asset - a possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the .
- A Contingent Liability - A present obligation that arises from past events, but is not recognized because:
  a) It is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or
  b) The amount of the obligation cannot be measured with sufficient reliability.

Legal and constructive obligations

Obligations

- **Legal**
  - Contract
  - Law / legislation

- **Constructive**
  - Established pattern of past practice
  - Published policies
  - Sufficiently specific current statement
  - Indication to other parties that certain responsibilities are accepted and creation of a valid expectation that they will be discharged

Recognition criteria – Provisions

A provision shall be recognized when:

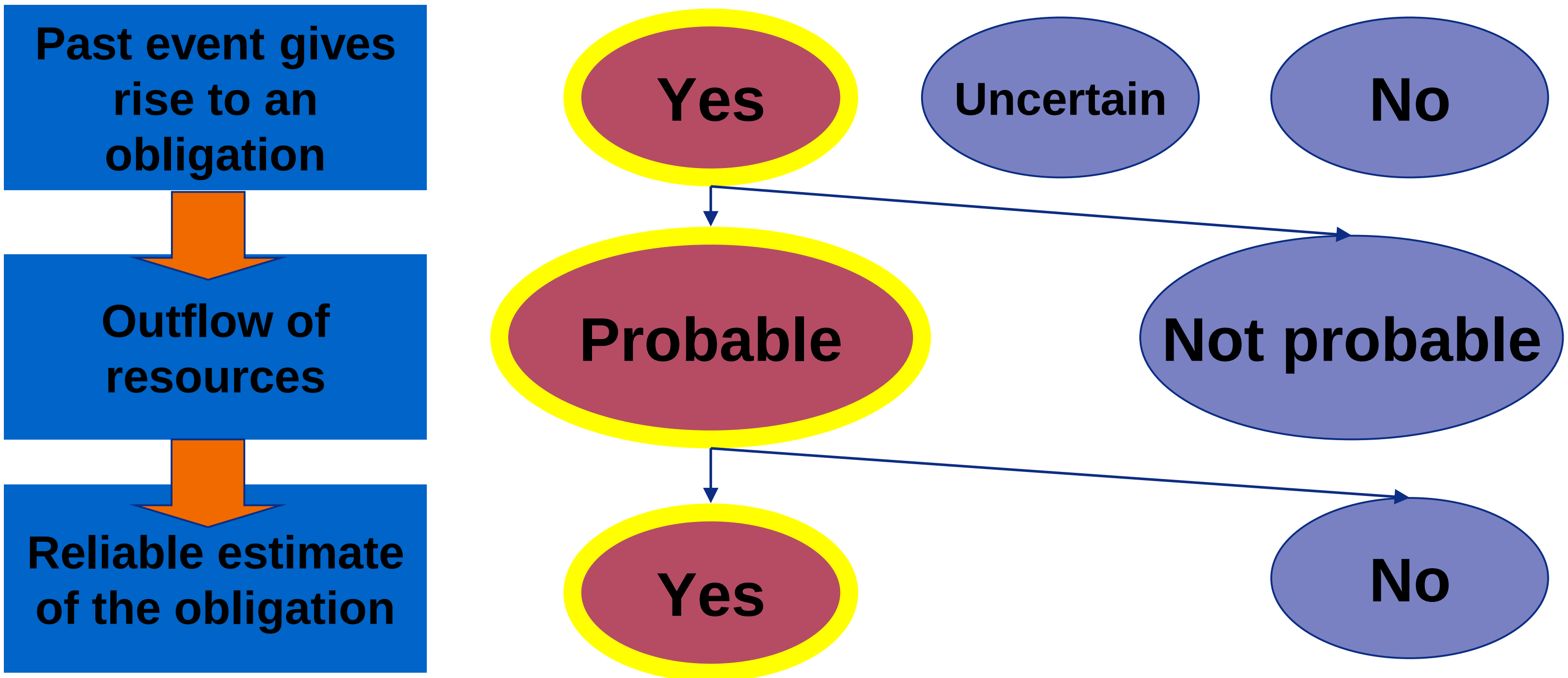
(a) An has a present obligation (legal or constructive) as a result of a past event;

(b) It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and

(c) A reliable estimate can be made of the amount of the obligation.

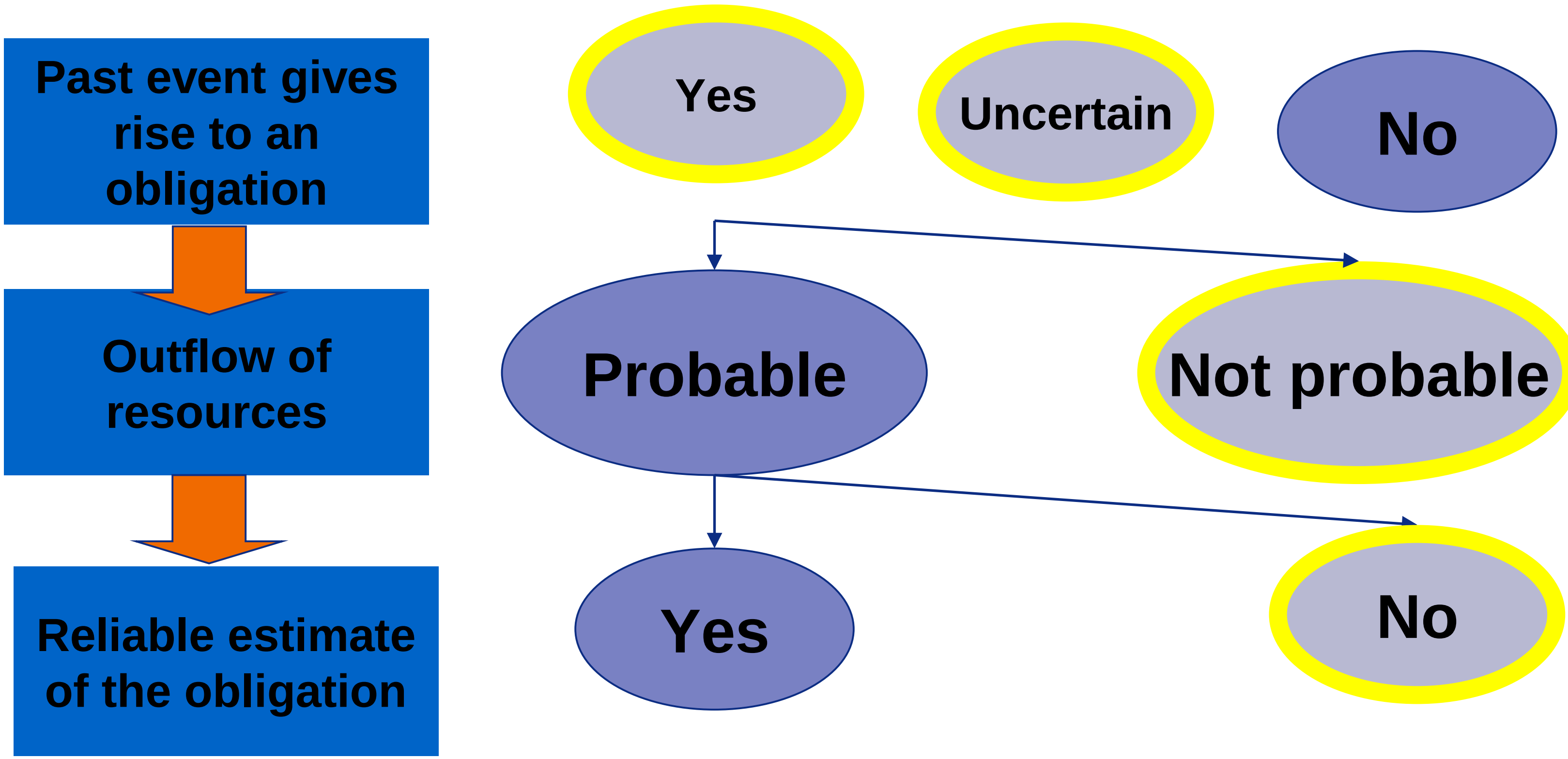
If these conditions are not met, no provision should be recognized.

Recognition criteria – Liabilities



Liability: Recognise & Disclose

Criteria – Contingent liabilities



Contingent liability: Disclose only*

***Exceptions: If outflow <u>remote</u> – do nothing;**

Criteria – Contingent assets

Inflow of benefits

Virtually certain	ASSET: Recognise
Probable	Contingent asset: DISCLOSE ONLY
Not probable	Contingent asset: DO NOTHING

Recognition criteria – Judgement

Possible guidelines:

♦ Virtually certain:	≥	90%
♦ Probable (more likely than not):	>	50%*
♦ Possible:	≤	50%
♦ Remote:	≤	10%

* In the standard

Recognition criteria – De-recognition of a provision

- **Through use**
  - Only for expenditures for which provision was recognised originally
  - As a result, expenditures do not affect profit or loss
- **Through revision of estimate**
  - If an outflow of economic benefits is no longer probable
  - Reversal affects profit or loss

Measurement

- Best estimate
  - Single item – most likely outcome
  - Large population of similar items – expected value
- Inherent risks and uncertainties to be considered
- Discounting required, when effect material
- Expected reimbursements (< / = provision) to be recognised as separate receivable, if virtually certain
- Expected gains from disposal of assets should not be recognised as reduction of provision

Measurement: Example 1

- **A sells a product with one year warranty**
  - 2016: number of items sold – 100,000
  - Costs to repair one item:
    - minor defects – 10 Shs.
    - major defects – 40 Shs.
  - Past statistics:
    - No defects for 75% goods
    - Minor defects for 20% goods
    - Major defects for 5% goods
- **What provision should be made for warranty costs?**

Measurement: Example 1 (solution)

- **Expected value of the liability in respect of items sold in 2016**

	Calculation	Result, Shs.
No defects	100,000 x 75% x 0	0
Minor defects	100,000 x 20% x 10	200,000
Major defects	100,000 x 5% x 40	200,000
Total		**400,000**

Measurement: Example 2

- **Measurement of a provision for a lawsuit**
  - Information provided by the legal advisors

	Estimated cost	Probability
Case is won	-	30%
Prior settlement	8	40%
Case is lost	12	30%

- **What provision should be made?**

Application: Prudence is not the ultimate virtue!

- **Do not provide for...**
  - Future operating losses (rainy days)
  - Currency risks
  - Political risks
  - Maintenance / refurbishment of own assets
  - General restructuring projects
  - General business risks

Application: Onerous contracts

Unavoidable costs > **Economic benefit**

Onerous contract

NB! If a contract can be terminated without paying penalty, then it is NOT onerous

Application: Onerous contracts (continued)

- Present obligation under the onerous contract should be recognised as a provision
- Measurement at the lower of (regardless of management’s intention):
  - Cost of terminating the contract; or
  - Net cost of continuing with the contract
- First review the assets dedicated to the onerous contract for impairment

Application: Restructuring costs

- Restructuring provisions require detailed formal plan or binding sale agreement
- must illustrate a demonstrable commitment by either:
  - Starting to implement that plan; or
  - Announcing its main features to those affected
- Timing: begin/end in a timeframe that makes significant changes unlikely
- A board decision alone is <u>not</u> sufficient!

Application: Details of a restructuring plan

- Business or part of the business concerned
- Principal locations
- Location, function and approximate number of employees who will be compensated for termination
- Cost entailed by the restructuring and not associated with ongoing activities
- Timing of implementation

Application: Details of a restructuring plan

Include if:

- Unavoidable, and
- Not associated with ongoing activities

Exclude if:

- Retaining or relocating continuing staff,
- Marketing, or
- Investment in new systems and distribution network

Application: Restructuring provisions in an acquisition

- The acquirer should recognise liabilities for terminating or reducing the activities of the acquiree as part of allocating the cost of the combination only
  - When the acquiree has, at acquisition date, an *existing* liability for restructuring recognised in accordance with IPSAS 19

Application: Repairs and maintenance

- **General principle**
  - Repairs and maintenance of own assets cannot be provided for
- **Example**
  - An airline is required by law to overhaul its aircraft once every three years
  - No present obligation that is independent of the ’s future actions
  - No provision is recognised
  - Depreciation takes account of the previously capitalised overhaul costs (IPSAS 17)

Disclosure – Light is the best policeman!

- **By category**
  - Brief description, timing, uncertainties of provisions
  - Detailed roll-forward of provisions
  - Expected and recognised reimbursements relating to provisions
  - Brief description and financial effect of any contingent assets and liabilities

Disclosure – Roll-forward by category

Opening balances

+ additional provisions recognised

- amounts used

- unused amounts reversed

+ increase in the discounted amount due to the passage of time and / or changes in the discount rate

= ending balances

- "Repurposing" of provisions prohibited!
- No comparative information

Disclosure – An exception

- Disclosure not required in the rare circumstances when disclosure would seriously prejudice the position of the in a dispute with another party

- But still disclose the general nature of the dispute and the fact that, and reason why, the information has not been disclosed

Disclosure - Identifying provisions: generally required categories

- Provisions for litigation
- Provisions for warranties
- Provisions for environmental obligations
- Provisions for loss orders / onerous contracts
- Provisions for restructuring costs

Recap quiz 1

- **Which of the following does <u>not</u> lead to recognising a provision?**

A. There is a legal or constructive obligation
B. There is a probable outflow of resources
C. There is a general risks of future losses
D. The amount can be estimated reliably

Answer: C

Recap quiz 2

- **Scenario**
  - D was involved in a litigation which was pending on 31 December 2016
  - The was the plaintiff
  - The litigation was settled on 30 April 2017 resulting in a gain to D
  - The fieldwork for the audit of the financial statements for 2016 was completed on 15 May 2017
- **Should the settlement be recognised in IPSAS financial statements for the year ended 31 December 2016?**

Answer: NO

Recap quiz 3

- **Scenario**
  - A mining entity operates in a country which does not require a mine operator to rehabilitate and restore mining sites
  - The entity has a publicly announced policy of restoring <u>all</u> of its sites
  - It expects that
    - 90% of the eventual cost will relate to the extraction of mineral reserves and
    - 10% to the initial development of the mine
- **What, if any, provision for site restoration should it recognise, and when?**

Recap quiz 3 – solution

- **Recognition criteria**
  - Legal or constructive obligation to restore the site
  - Damage already has occurred
  - It is probable that a restoration expense will be incurred
  - Costs can be estimated reasonably
- **The mining entity would recognise an obligation (a liability) for site restoration when all of the above criteria are met**

Conclusion

- Discussion

- Questions?