

Provisions and contingencies (Lecture A643 – 23.31 minutes)

In practice, the issue surrounding provisions for assets and liabilities and contingent assets and liabilities can be a complex one. Care needs to be taken to not only account for provisions and contingencies correctly, but also to recognise any provisions at an appropriate amount; particularly where there may be associated tax implications as HM Revenue and Customs (HMRC) may disallow excessive provisions where tax relief has been obtained on such provisions. With interest and penalties potentially being levied by HMRC, excessive provisions can prove costly.

The requirements for provisions and contingencies are outlined in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 21 *Provisions and Contingencies*.

Provisions for liabilities

In accounting, the term 'provision' is interchangeable; for example, a 'provision for bad debts' or 'provisions for depreciation'. In these contexts, the term 'provision' is the adjustment to carrying values in the financial statements rather than in the same context as that used in Section 21 as a provision for a liability.

In respect of provisions for liabilities, FRS 102 says that a provision is a liability whose timing or amount is uncertain. The fact that there is uncertainty in respect of the timing and amount is why it is important to ensure that any provisions made in the financial statements would be able to stand up to scrutiny in the event, for example, of a HMRC enquiry into the entity's corporation tax return.

There are three criteria which have to be met before a provision can be recognised in the financial statements:

1. The entity must have a present obligation that has arisen because of something that has occurred in the past.
2. It is more likely than not that the entity will have to transfer some economic benefit (eg cash or another form of asset) in order to settle the obligation.
3. The amount of the obligation can be measured with some degree of reliability (ie a reliable estimate can be made).

Where any of the above criteria **cannot** be met, a provision cannot be recognised in the financial statements and a contingent liability will be disclosed (if material).

All three criteria have to be met (it is not one or two out of the three). This is to stop companies from deliberately recognising provisions that are unlikely to crystallise. Prior to the introduction of accounting standards in this area, it was not uncommon for companies to deliberately manipulate the profit (or loss) of a business by creating or releasing provisions that effectively would not crystallise. This act of manipulation was coined 'big bath accounting' or 'big bath provisioning' and worked by focussing on the profit or loss of the business first and then working upwards through the profit and loss account until a desired profit or loss figure was arrived at. The requirement to meet all three criteria was designed to outlaw the act of big bath provisions.

Creation of an 'obligation'

Not all obligations will give rise to a provision being recognised in the financial statements. Only those obligations which exist at the balance sheet date that have arisen as a result of a past event will give rise to a provision. This means that the reporting entity has no realistic alternative to settling the obligation which can be created in one of two ways:

- by way of a **legal** obligation; or
- by way of a **constructive** obligation.

Legal obligation

A legal obligation is one which can be enforced by law. It will usually be obvious when a company has a legal obligation, for example by way of agreement or a court order. Provisions can also be made for normal day-to-day transactions, such as a provision for goods and/or services received by the period-/year-end but not yet invoiced; ie an accrual.

A business cannot base a provision on its future actions. Paragraphs 21.6 of FRS 102 is strict on its approach to an entity's future actions because such actions do not meet the definition of a provision and the entity has not got an obligation at the balance sheet date for its future actions, regardless of how likely or unlikely they are to occur. An obligation arises because of an obligating event and hence it follows that the obligating event must have occurred at, or by, the balance sheet date in order to give rise to a provision.

Example – No obligating event

In 2016, legislation was passed which requires an entity operating in the chemical industry to reduce its effluent levels by 40% by 31 October 2018 which means investing in additional denitrification processes (the process by which nitrogen is removed from water).

At 31 December 2018, which is the company's year-end, the entity had not done anything to reduce its effluent levels. The financial controller has included a provision for the costs that she estimates will be needed to complete the work.

The provision should not be included in the accounts to 31 December 2018. This is because there is no obligating event (the investment in the additional denitrification processes).

At 31 December 2019 the company had still not made any attempts to reduce its effluent levels. The financial controller has made a provision again on the grounds that the date has now passed for the company to have completed this work.

There is still no obligating event at the year-end 31 December 2019 because the company has still not done anything to invest in additional denitrification costs. The company may need to make a provision for fines and penalties for non-compliance with the legislation but this would only be the case if it were to be probable that such fines and penalties will be imposed and a reliable estimate could be made of the

penalties. There is an obligating event in respect of the fines and penalties which is the non-compliance with the legislation.

Constructive obligation

A constructive obligation arises when an entity creates an expectation in the mind-sets of others that it will discharge its obligations. This usually arises because of the entity's past practice, published policies or by way of a specific statement.

Example – Constructive obligation

A retailer of office equipment has a sign above its cash desk informing customers that it will give refunds on goods purchased provided the item is returned within 14 days from the date of purchase. This applies regardless of whether the goods are faulty or not.

In this example, the published policy of the retailer goes over and above any legal obligation but a constructive obligation arises from the retailer's established published practice. Conversely, any ad-hoc refunds would be less clear in establishing any obligation.

Extra care should be taken where constructive obligations are concerned because these are less clear-cut than legal obligations and in order for a constructive obligation to be recognised as a provision in the financial statements, an expectation must be created in the mind-sets of those affected that the entity will discharge its obligations.

Recognition of a provision in the financial statements

FRS 102 says that where a provision meets the recognition criteria, it should be recognised at the best estimate of the amount that will be required to settle the obligation. When a provision involves a large population of items, the estimate must reflect the weighting of all possible outcomes by their associated probabilities.

Example – Provision for defective goods

A well-established company sells electrical products such as dishwashers, washing machines, TV and audio equipment. It sells goods to the general public with a warranty which covers customers for the costs of repair that occur during the first six months from the date of purchase. The company is preparing its financial statements for the year-ended 31 December 2018 and calculations carried out by the financial controller suggest that if all the products sold contained minor defects, the costs of repair would be £1 million. If major defects occurred in all the products, the costs of repair would be £4 million.

Management have concluded that past experience, and future expectations, suggest that for the coming year 75% of the goods sold will contain no defects; 20% will contain minor defects and 5% will have major defects.

The provision for the year is calculated as follows:

	£
75% x nil	nil
20% x £1 million	200,000
5% x £4 million	<u>200,000</u>
Total provision	<u>400,000</u>

Contingent liabilities

Contingent liabilities are not recognised in the financial statements because they fail to meet the recognition criteria for a provision. There is, however, one exception to this rule which applies to contingent liabilities which have been assumed by the acquirer of an acquiree in a business combination and for which paragraphs 19.20 and 19.21 of FRS 102 apply (Section 19 deals with business combinations and goodwill). These are examined in Section 1 of these course notes.

Contingent liabilities are disclosed in the notes to the financial statements, unless the possibility of an outflow of economic benefit resources is considered to be remote.

Example – Contingent liability

A company has made a provision for damages amounting to £10,000 in its financial statements for the year-ended 31 December 2018 in respect of a legal claim brought against the company by one of its customers. The legal advisers have advised the company that at the reporting date, they are uncertain as to the potential outcome of the case. The case is considered to be material to the company.

The company should not recognise a provision for damages because it is not 'probable' that an outflow of resources will be required to settle the case. The legal advisers are unsure as to the outcome of the case. In such situations, disclosure of a contingent liability in the notes to the financial statements should be made.

Contingent assets

A contingent asset is directly the opposite of a contingent liability and, again, is not reflected in the financial statements of the reporting entity. Contingent assets will only be recognised in the financial statements if it is 'virtually certain' that an entity will realise the contingent asset (for example, an insurance company agreeing to pay out a claim to the company). The recognition

criterion is stricter because of the underpinning principle in financial reporting that assets cannot be stated in an entity's balance sheet at any more than recoverable amount.

Offsetting provisions

There may be occasions when a company has to recognise a provision for liabilities in its financial statements as the recognition criteria have been met, but that liability will be reimbursed by a third party (such as an insurance company).

In these cases, it is important that the entity recognises the asset and the liability separately; they must **not** be offset in the balance sheet because this would mean assets and liabilities are both understated; thus presenting a misleading financial position. Section 21 does, however, allow the expense relating to the provision in the profit and loss account to be offset, thus presenting the expense net of the reimbursement in the profit and loss account.

Disclosures for provisions

The disclosure requirements in respect of provisions are outlined in paragraph 21.14 of FRS 102.

For each class of provision, the financial statements should disclose:

- (a) a reconciliation showing:
 - (i) the carrying value at the beginning and end of the period;
 - (ii) additions to the provision during the period, including any adjustments that have arisen due to changes in measuring the discounted amount;
 - (iii) amounts charged against the provision during the period; and
 - (iv) unused amounts which have been reversed during the period;
- (b) a brief description of the nature of the obligation together with 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 value of any expected reimbursement – this should also state the amount of any asset that has been recognised for the reimbursement.

Comparative information for previous periods is not required.

Remember that where estimates are involved, unless the company is applying Section 1A it must disclose information about key sources of estimation uncertainty and about significant judgements (FRS 102 8.6 and 8.7). Whether a contingent liability or provision exists, or how much that amount is may well be areas where such disclosures are required.

Disclosures for contingent liabilities

The disclosure requirements for contingent liabilities are outlined in paragraph 21.15 of FRS 102.

FRS 102 requires, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, where practicable:

- (a) an estimate of the contingent liability's financial effect;
- (b) an indication of the uncertainties relating to the amount or timing of any outflow; and
- (c) the possibility of any reimbursement.

Where a reporting entity is unable to make one, or more, of these disclosures, it must state that fact.

Disclosures for contingent assets

Paragraph 21.16 of FRS 102 requires an entity to disclose a description of the nature of the contingent assets as at the reporting date. In addition, and when practicable, the entity should also provide an estimate of their financial effect. Where it is not practicable to provide an estimate of their financial effect, that fact should be stated.

Prejudicial disclosures

Paragraph 21.17 of FRS 102 addresses the issues concerning prejudicial disclosures. These are where any disclosures made to comply with the requirements of the standard could be expected to seriously prejudice the position of the entity involved in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset.

Paragraph 21.17 is heavily restrictive in that it says 'In extremely rare cases ...'. The term 'extremely rare cases' is not defined in FRS 102 and in real life, there are a wide range of circumstances where entities may be in negotiation with third parties in respect of a provision, contingent liability or contingent asset. The key point to emphasise is that paragraph 21.17 concerns **disclosure requirements only**. It follows, therefore, that paragraph 21.17 does not exempt a reporting entity from making, say, a provision for a liability. It might also be the case that a provision for liability is reimbursed from a third party (such as an insurance company) and where this is the case and a reimbursement asset has been recognised on the grounds that its receipt is virtually certain, the prejudicial disclosure exemption may extend to the reimbursement asset (although a reporting entity would disclose which asset balance is affected).

The prejudicial disclosure exemption will not be available in respect of the provision, contingent liability or contingent asset once the dispute has been resolved.

Prejudicial disclosures: provisions

FRS 102 requires at least the following where provisions are covered by the prejudicial disclosure exemption:

- '(a) a table showing the reconciliation required by paragraph 21.14(a) in aggregate, including the source and application of any amounts transferred to or from provisions during the reporting period;*
 - (b) particulars of each provision in any case where the amount of each provision is material; and*
- FRS 102, para 21.17*

- (c) *the fact that, and reason why, the information required by paragraph 21.14 has not been disclosed.'*

Prejudicial disclosures: contingent liabilities

FRS 102 requires at least the following where contingent liabilities are covered by the prejudicial disclosure exemption:

- (a) *particulars and total amount of any contingent liabilities (excluding those which arise out of insurance contracts) that are not included in the statement of financial position;* *FRS 102, para 21.17*
- (b) *the total amount of contingent liabilities which are undertaken on behalf of or for the benefit of:*
- (i) *any **parent** or fellow **subsidiary** of the entity;*
 - (ii) *any subsidiary of the entity; or*
 - (iii) *any entity in which the reporting entity has a participating interest,*
- shall each be stated separately; and*
- (c) *the fact that, and reason why, the information required by paragraph 21.15 has not been disclosed.'*

Prejudicial disclosures: contingent assets

FRS 102, para 21.17 requires an entity to disclose the general nature of the dispute, together with the fact that, and the reason why, the information required by paragraph 21.16 has not been disclosed.