IAS 37
Provisions, contingent liabilities and contingent assets

1. Objective

IAS 37 prescribes the accounting and disclosure for all provisions, contingent liabilities and contingent assets. It indicates how to measure and account for these items. The objective of the Standard is to ensure consistency of and comparability of treatment for provisions.

This Standard does not apply to certain items, in particular:

- financial instruments (including guaranties) (IFRS 9);
- income taxes (IAS 12);
- leases (IFRS 16); although IAS 37 does apply to short-term leases and leases for which the underlying asset is of low value, as well as leases which are onerous on their commencement date as defined under IFRS 16;
- employee benefits (IAS 19);
- contracts between insurance companies and policyholders falling within the scope of application of IFRS 17.
- income from ordinary activities, including in particular contracts with customers (IFRS 15). However, IFRS 15 does not contain specific provisions on onerous contracts with customers and therefore, IAS 37 will apply.

2. Scope

2.1 Definitions

A **provision** is a liability of uncertain timing or amount.
A **liability** is a present obligation arising from past events, the settlement of which will translate into an outflow of resources embodying economic benefits.

A **contingent liability** may be defined as:

- a **possible obligation arising from past events** whose existence will be confirmed by the occurrence or non-occurrence of events that are not wholly within the control of the entity,

- or a **present obligation** that is not recognized because it does not meet the required accounting criteria (for example, because the obligation relates to outflows of resources that are not probable or which cannot be measured reliably).

2.2 Accounting for provisions

A provision must be recognized only when an entity has a present obligation arising from a past event, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.
If it is not clear whether there is a present obligation, recognition or non-recognition depends on management's assessment of the probability of it occurring.

An obligation may be:

- legal - arising from a contract (end-of-year discount, for example), legislation, or operation of law, or
- constructive - in particular when an entity has indicated to other parties by its past actions that it will accept certain responsibilities, thus creating a valid expectation on the part of those other parties that the entity will discharge those responsibilities (warranties offered to customers, for example).

Example 1: Company X manufactures and retails vacuum cleaners with a 3-year warranty.
A statistical analysis of returns for this type of household appliance provided the following information:
– 15% of vacuum cleaners break down within 3 years;
– on average, 45% of these breakdowns happen in the year they were sold, 30% in the following year and 25% in the year after that.
The average repair cost is 150 per appliance.

The provision for warranties in year N must be calculated.
Given that company X has a linear turnover for each reporting period, it sold:

900,000	units in year N–3	1,000,000	units in year N–2
1,125,000	units in year N–1	1,300,000	units in year N

➢ *For simplification purposes, we assume that the warranty period would begin on 1 January N+1 and would terminate on 31 December N+3.*

The data for year N-1 is summarized in the table below.

Number of breakdowns	At end of N-2	At end of N-1	At end of N	At end of N+1	At end of N+2
Production in N-3 900,000	60,750 900,000 x 15% x 45%	40,500 900,000 x 15% x 30%	**33,750 900,000 x 15% x 25%**		
Production in N-2 1,000,000		67,500 1,000,000 x 15% x 45%	**45,000 1,000,000 x 15% x 30%**	**37,500 1,000,000 x 15% x 25%**	
Production in N-1 1,125,000			**76,000 1,125,000 x 15% x 45%**	**50,600 1,125,000 x 15% x 30%**	**42,200 1,125,000 x 15% x 25%**

The provision at end of year N–1 corresponds to the amounts shown in bold type, i.e.: (33,750 + 45,000 + 37,500 + 76,000 + 50,600 + 42,200) × 150 = 42,757,500.

The data for year N-1 is summarized in the table below.

Number of breakdowns	At end of N-2	At end of N-1	At end of N	At end of N+1	At end of N+2	At end of N+3
Production in N-3 900,000	60,750 900,000 x 15% x 45%	40,500 900,000 x 15% x 30%	33,750 900,000 x 15% x 25%			
Production in N-2 1,000,000		67,500 1,000,000 x 15% x 45%	45,000 1,000,000 x 15% x 30%	**37,500 1,000,000 x 15% x 25%**		
Production in N-1 1,125,000			76,000 1,125,000 x 15% x 45%	**50,600 1,125,000 x 15% x 30%**	**42,200 1,125,000 x 15% x 25%**	
Production in N 1,300,000				**87,800 1,300,000 x 15% x 45%**	**58,500 1,300,000 x 15% x 30%**	**48,800 1,300,000 x 15% x 25%**

The provision at the end of year N corresponds to:
(37,500 + 50,600 + 42,200 + 87,800 + 58,500 + 48,800) × 150 = 48,810,000.
Consequently the amount provisioned in year N is equal to:
48,810,000 – 42,757,500 = 6,052,500.

➢ *For simplification purposes, the provision is not discounted.*

If reimbursement of a provisioned expense is expected with sufficient certainty, it is carried for an amount that must not exceed the amount of the provision. The reimbursement is treated as a separate asset, but the expected income may be offset by the expense related to the provision in the profit and loss statement.

3. Accounting impact

3.1 Provisions and other liabilities

Provisions differ from other liabilities because of the uncertain nature of their timing or amount.
The amount recognized as a provision should be the most relevant and reliable estimate of the expenditure required to settle the obligation. It may be necessary to discount to present value the amounts determined initially. In this case, any future revision of the provision relating to the effect of discounting (referred to as the unwinding of the discount) should be recognized as a financial expense.
Provisions should be reviewed at the end of each accounting period taking account of new information, so as to reflect the current best estimate of the obligation.
Provisions should be used only for expenditures for which the provision was initially set up, and may not be used for expenses of a different nature or origin.
Provisions must not be recognized for **future operating losses.**

IAS 37 also considers more specifically **two types of provisions:**

- provisions for **onerous contracts**: for such contracts, a provision must be measured at an amount which reflects the difference between the costs of performing the contract obligation and the expected income or benefits which are expected to arise from the contract;
- provisions for **restructuring**: restructuring events, i.e. sale or termination of a business line, closure of sites, elimination of a layer of management, or the fundamental reorganization of an entity, justify provisioning only when certain conditions are satisfied.

An entity must have an obligation which derives from a detailed restructuring plan. The restructuring plan must be formal, programmed, measured and announced to those who will be affected, so as to create a valid expectation on the part of those other parties that the entity will implement the plan.
A restructuring provision must include only the direct expenditures arising from the restructuring plan and not expenditures related to the future activities of the entity.

Example 2: Company Y announces publicly that one of its sales outlets will close down on 20 December N. The estimated expenses arising from this restructuring plan are:

Redundancy costs	100,000
Cost to transfer equipment that will be disposed of	12,000
Cost to move equipment that can be used elsewhere	20,000
Cost to retrain remaining staff	14,000
Rents owed after closing down (up until the end of the lease)	13,000
Reorganization of the retail network	7,000
Compensation paid to local suppliers for early termination of contracts	15,000
Payroll and other personnel costs up until the completion of the move	16,000
Identifiable future operating losses	8,000

IAS 37 does not permit all of these expenses to be taken into consideration when calculating the amount of the provision required as at 31 December N. Only the expenses directly related to the restructuring plan should be considered, and not those related to continued business activities, i.e. the provision should consist only of the following:

Redundancy costs	100,000
Cost of moving equipment that will be disposed of	12,000
Rents owed after closing down (up until the end of the lease)	13,000
Compensation paid to local suppliers for early termination of contracts	15,000
Payroll and other personnel costs up until the completion of the move	15,000
Total	**156,000**

3.2 Contingent liabilities

An entity must not recognize contingent liabilities, but does have to **disclose** these in the notes to the financial statements.
A contingent liability is an obligation arising as a consequence of past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events which are beyond the control of the entity or whose amount cannot be measured with sufficient reliability.

3.3 Contingent assets

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 unplanned, **unpredictable future events**, but that would be likely to generate an inflow of economic benefits to the entity. Because of its uncertain nature, a contingent asset is not recognized in the financial statements and is disclosed in the notes only if an inflow of economic benefits is probable.

4. Disclosure

For each class of provision, an entity must disclose:

- the carrying amount at the beginning and end of the reporting period;
- additional provisions made in the period and increases to existing provisions;
- amounts used, as well as amounts not used and reversed during the reporting period;
- a description of the circumstances that gave rise to the provisions and the reasons supporting provisioning and measurements;
- the effects of discounting on existing provisions.

In addition, an entity must disclose a **description of contingent assets and liabilities**, uncertainties regarding their outcome and an estimate of their impact.
In extremely rare cases, an entity needs not disclose certain of the information required by the Standard. This can only be applied where disclosure of information can be expected to prejudice seriously the position of an entity in dispute with another party or parties. In such cases, the entity need not disclose the information but should disclose the reasons why the information has not been disclosed.