

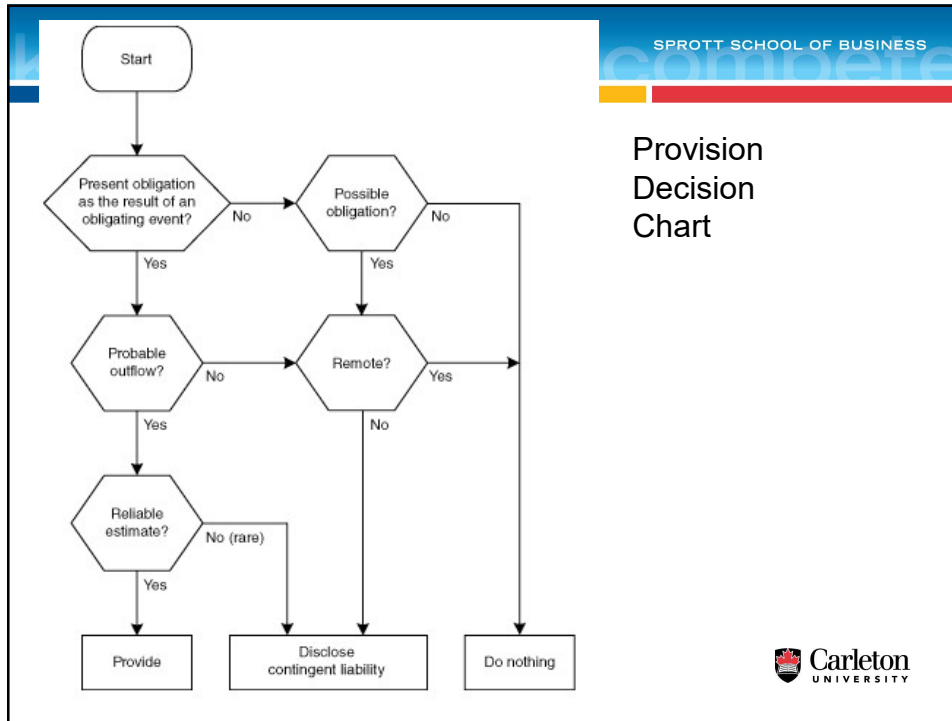
Provisions and Contingencies – Part 1

knowledge to compete

The knowledge to compete

Liabilities

- a liability is defined as a **present obligation** arising from **past events**, the settlement of which is expected to result in an **outflow of economic benefits**
- a financial liability is a financial instrument – a contract that gives rise to a financial asset of one party and a financial liability or equity instrument of another party
- a non-financial liability is any liability that is not a financial liability i.e. it has no offsetting financial asset on the books of the other party (i.e. warranty liabilities)



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Provisions

Defined as a liability of uncertain timing and amount

A provision should be recognized when:

- (a) an entity has a present obligation (legal or constructive) as a result of a past event -> obligating event;
- (b) it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (c) a reliable estimate can be made of the amount of the obligation.

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Provisions - cont' d

A *constructive obligation* is an obligation that derives from an entity's actions where:

- (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 certain 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. (IAS 37.10)

Example: refund policy

Measurement of Provision

- amount to be recorded = the best estimate or expected value of the amount required to settle the obligation
- best estimate is defined as '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 3rd party at that time'
- if there is a range of possible outcomes, each associated with probabilities, then the expected value can be calculated (but only if we are dealing with a population of events)

Measurement of Provision – cont'd

- single event: generally measure based on the most likely outcome
 - other possible outcomes are still considered: where other possible outcomes are either higher or lower than the most likely outcome, the best estimate will be a higher or lower amount
- if cash outlays are expected over time, they have to be discounted if the effect of discounting is material
- must be re-estimated annually
- only in the rare case where no reliable estimate can be made does a liability exist that cannot be recognized

Single Event Examples

Example 1: an entity faces a legal claim: 30% chance outcome = \$0; 70% chance outcome is \$3,000,000

- expected value is not valid as the outcome will either be \$0 or \$3M (i.e. outcome will never be \$2,100,000)
- accrue most likely outcome of \$3,000,000

Example 2: an entity is required to replace a major component of an asset under warranty - cost of replacement is \$1M; 30% chance of a single failure; 50% chance of 2 failures and 20% chance of 3

- Most likely outcome = 2 failures; accrue \$2,000,000

Single Event Examples – cont'd

Example 3: an entity is required to replace a major component of an asset under warranty - cost of replacement is \$1M; 40% chance of a single failure; 30% chance of 2 failures and 30% chance of 3

- Most likely outcome = 1 failure costing \$1,000,000
- But... the most likely outcome has a probability of 40% - there is a 60% probability that the cost will be higher
- Expected value = $(1 \times .4) + (2 \times .3) + (3 \times .3) = 1.9M$
- Outcome closest to \$1.9M is two failures – recognize a provision for \$2M

Contingent Liabilities

A *contingent liability* is defined as:

- (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; or
- (b) a present obligation that arises from past events but is not recognized because:
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) the amount of the obligation cannot be measured with sufficient reliability.

Contingent Liabilities - cont' d

- contingent liabilities are disclosed only - not accrued
the following information has to be disclosed:
 - an estimate of the financial effect,
 - an indication of the uncertainties arising to the amount or timing of any outflow, and,
 - the possibility of any reimbursement (i.e. when some or all of the expenditure required to settle the obligation is expected to be reimbursed by another party).

Contingent Liabilities - cont' d

- In the extremely rare case that disclosure of information can be expected to prejudice seriously the position of the entity, the entity can opt to not disclose the information but needs to disclose the general nature of the dispute together with the fact that, and reason why, the information has not been disclosed

Events after the reporting period

Two types:

- adjusting events after the reporting period - those which provide further evidence of conditions which existed at the financial statement date - these will result in an adjustment to the financial statements, and
- non-adjusting events after the reporting period - those which are indicative of conditions which arose subsequent to the financial statement date that do not provide further evidence of conditions which existed at the financial statement date - if material, these have to be disclosed in the notes to the financial statements

Debt Renegotiation

- if a long-term liability is due within 12 months of the reporting date and the terms are being negotiated to extend the due date, the debt can only remain classified as long-term if the arrangements are formalized before the end of the year
 - if the arrangements are formalized between the financial reporting date and the financial statements release date, then the long-term liability has to be reclassified as short-term on the statement of financial position

Warranties

Two types of warranties:

1. expense warranty: the warranty is an integral part of the sale and is accounted for as a provision. The total expected warranty expense is recorded in the year the related item is sold:
 - dr. Warranty Expense; cr. Warranty Liability
 - although an individual warranty's probability of occurrence is less than 50%, the class of all warranties as a whole has a probability of occurrence $> 50\%$, thus a provision

Warranties

Two types of warranties:

2. sales warranty: the warranty is sold separately:
accrue the revenues over the life of the warranty
using the percentage of completion approach.
Record expenses of servicing warranty as incurred.

Customer Loyalty Programs

- treated as deferred revenues and reduce the amount of revenue realized (dr. Revenues; cr. Deferred Revenues)
 - deferred revenue = retail value of the points granted multiplied by the estimated % redemption rate
- as points are redeemed, the retail value of the redemption reduces the deferred revenue balance
- ASPE treats customer loyalty programs as an expense and is measured at cost
 - incentive program cost = value of the points granted at cost multiplied by the estimated % redemption rate

Contingent Assets

- example: a legal claim against another entity for patent infringement
- contingent assets are not recognized
- contingent assets are disclosed, but only when an inflow of economic benefits is probable
- when the realization of the contingent asset is virtually certain, then the related asset is no longer a contingent asset and its recognition is appropriate

Reimbursements

- a reimbursement can be recognized, but only if it is virtually certain that reimbursement will be received if the entity settles the obligation
- the reimbursement is treated as a separate asset
- the amount of the reimbursement cannot exceed the amount of the provision
- the expense relating to the provision is presented net of the amount recognized for a reimbursement

Onerous Contracts

- 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
- the present obligation under an onerous contract shall be recognized and measured as a provision



Restructurings

- a restructuring is a program 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.
- a constructive obligation to restructure arise only when an entity...
 - has a detailed formal plan for the restructuring, and
 - has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement the plan or announcing its main features to those affected by it



Restructurings - cont' d

- a restructuring provision shall include only the direct expenditures arising from the restructuring, which are both:
 - necessarily entailed by the restructuring, and
 - not associated with the ongoing activities of the entity
- excludes: retraining or relocating continuing staff, marketing or investments in new systems and distribution networks
 - these relate to the future conduct of the business

Proposed Law

- If a law has been proposed, but not enacted, a legal obligation exists only if it is virtually certain the legislation will be enacted as drafted

Disclosure Requirements - IFRS

- For each class or provisions:
 - a reconciliation of the movement between the opening and ending balances
 - A brief description of the nature of the obligations and the expected timing of any resulting outflows of economic benefits
 - An indication of the uncertainties about the amount or timing of those outflows
 - The amount of any expected reimbursement; the amount of any asset recognized

From Onex Corporation – 2014 Annual Report

	Restructuring ^(c)	Self-Insurance ^(d)	Warranty ^(e)	Other ^(f)	Total
Current portion of provisions	\$ 42	\$ 85	\$ 81	\$ 123	\$ 331
Non-current portion of provisions	6	90	125	198	419
Balance – December 31, 2013	\$ 48	\$ 175	\$ 206	\$ 321	\$ 750
Charged (credited) to statements of earnings:					
Additional provisions	74	195	77	117	463
Unused amounts reversed during the year	(4)	(1)	(15)	(46)	(66)
Acquisition of subsidiaries	-	2	-	35	37
Disposition of operating companies	(1)	(43)	(69)	(5)	(118)
Transfer to discontinued operations	-	(41)	-	(4)	(45)
Amounts used during the year	(85)	(186)	(64)	(78)	(413)
Increase in provisions due to passage of time and changes in discount rates	-	-	-	7	7
Other adjustments	-	(1)	(8)	(9)	(18)
Balance – December 31, 2014	\$ 32	\$ 100	\$ 127	\$ 338	\$ 597
Current portion of provisions	(26)	(47)	(71)	(129)	(273)
Non-current portion of provisions	\$ 6	\$ 53	\$ 56	\$ 209	\$ 324

Contingent Liabilities - ASPE

- what IFRS refers to as provisions and contingencies are grouped and called contingent liabilities under ASPE
- ASPE defines the range of probabilities as follows:
 - Likely: the chance of occurrence of the future event is high
 - Unlikely: the chance of occurrence is slight
 - Not determinable
- accrue if two conditions are met:
 - It is likely that a future event will confirm that an asset had been impaired or a liability incurred at the date of the financial statements, and
 - the amount of the loss can be reasonably determined

Contingent Liabilities – ASPE (cont'd)

- contingent gains are not accrued; can be disclosed if it is likely that a future event will confirm the gain
- if you have a range of possible outcomes of a contingent liability that is to be recorded, ASPE requires you to record the lower of the range and disclose the remaining exposure
- no discounting
- if a long-term liability is due within 12 months of the reporting date and the terms are being negotiated to extend the due date, the debt can remain classified as long-term as long as the arrangements are formalized before the financial statements are issued

Contingent Liabilities – ASPE (cont'd)

- Disclosure:
 - The occurrence of the confirming event is likely but the amount cannot be estimated
 - The occurrence of the confirming event is likely and has been accrued but there exists an exposure to loss in excess of the amount accrued
 - The occurrence is not determinable
- Minimum note disclosure:
 - The nature of the contingency
 - An estimate of the loss or a statement to the effect that such an estimate cannot be made
 - Any exposure to loss in excess of the amount accrued