

AS 29 – Provisions, Contingent Liabilities and Contingent Assets

Workshop on Accounting Standards-
19 December 2013

Summary of AS 29

Objective

- The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The key principle established by the Standard is that a provision should be recognised only when there is a liability i.e. a present obligation resulting from past events. The Standard thus aims to ensure that only genuine obligations are dealt with in the financial statements – planned future expenditure, even where authorised by the board of directors or equivalent governing body, is excluded from recognition.

Summary of AS 29

Scope

- AS 29 excludes obligations and contingencies arising from:
 - financial instruments that are in the scope of [AS 30/ 31/ 32](#) *Financial Instruments: Presentation / Disclosures / Recognition and Measurement, recorded at fair value*
 - non-onerous executory contracts
 - insurance contracts, but AS 29 does apply to other provisions, contingent liabilities and contingent assets of an insurer
 - items covered by another AS. For example, [AS 7](#) *Construction Contracts* applies to obligations arising under such contracts; [AS 22](#) *Income Taxes* applies to obligations for current or deferred income taxes; [AS 19](#) *Leases* applies to lease obligations; and [AS 15](#) *Employee Benefits* applies to pension and other employee benefit obligations;

Summary of AS 29

Key definitions

Provision: a liability of uncertain timing or amount.

Liability:

- present obligation as a result of past events
- settlement is expected to result in an outflow of resources (payment)

Contingent liability:

- a possible obligation depending on whether some uncertain future event occurs, or
- a present obligation but payment is not probable or the amount cannot be measured reliably

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 entity.

Summary of AS 29

Recognition of a provision

- An entity must recognise a provision if, and only if:
 - a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event),
 - payment is probable ('more likely than not'), and
 - the amount can be estimated reliably.
- An obligating event is an event that creates a legal or constructive obligation and, therefore, results in an entity having no realistic alternative but to settle the obligation.
- A constructive obligation arises if past practice creates a valid expectation on the part of a third party, for example, a retail store that has a long-standing policy of allowing customers to return merchandise within, say, a 30-day period.

Summary of AS 29

Recognition of a provision

- A possible obligation (a contingent liability) is disclosed but not accrued. However, disclosure is not required if payment is remote.
- In rare cases, for example in a lawsuit, it may not be clear whether an entity has a present obligation. In those cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date. A provision should be recognised for that present obligation if the other recognition criteria described above are met. If it is more likely than not that no present obligation exists, the entity should disclose a contingent liability, unless the possibility of an outflow of resources is remote.

Summary of AS 29

Measurement of provisions

- The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date, that is, the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party. This means:
 - Provisions for one-off events (restructuring, environmental clean-up, settlement of a lawsuit) are measured at the most likely amount.
 - Provisions for large populations of events (warranties, customer refunds) are measured at a probability-weighted expected value.
- In reaching its best estimate, the entity should take into account the risks and uncertainties that surround the underlying events.

Summary of AS 29

Measurement of provisions

- If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised as a separate asset, and not as a reduction of the required provision, when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The amount recognised should not exceed the amount of the provision.
- In measuring a provision consider future events as follows:
 - forecast reasonable changes in applying existing technology
 - ignore possible gains on sale of assets
 - consider changes in legislation only if virtually certain to be enacted

Remeasurement of provisions

- Review and adjust provisions at each balance sheet date
- If an outflow no longer probable, provision is reversed.

Summary of AS 29

Use of provisions

- Provisions should only be used for the purpose for which they were originally recognised. They should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources will be required to settle the obligation, the provision should be reversed.

Contingent liabilities

- Since there is common ground as regards liabilities that are uncertain, AS 29 also deals with contingencies. It requires that entities should not recognise contingent liabilities – but should disclose them, unless the possibility of an outflow of economic resources is remote.

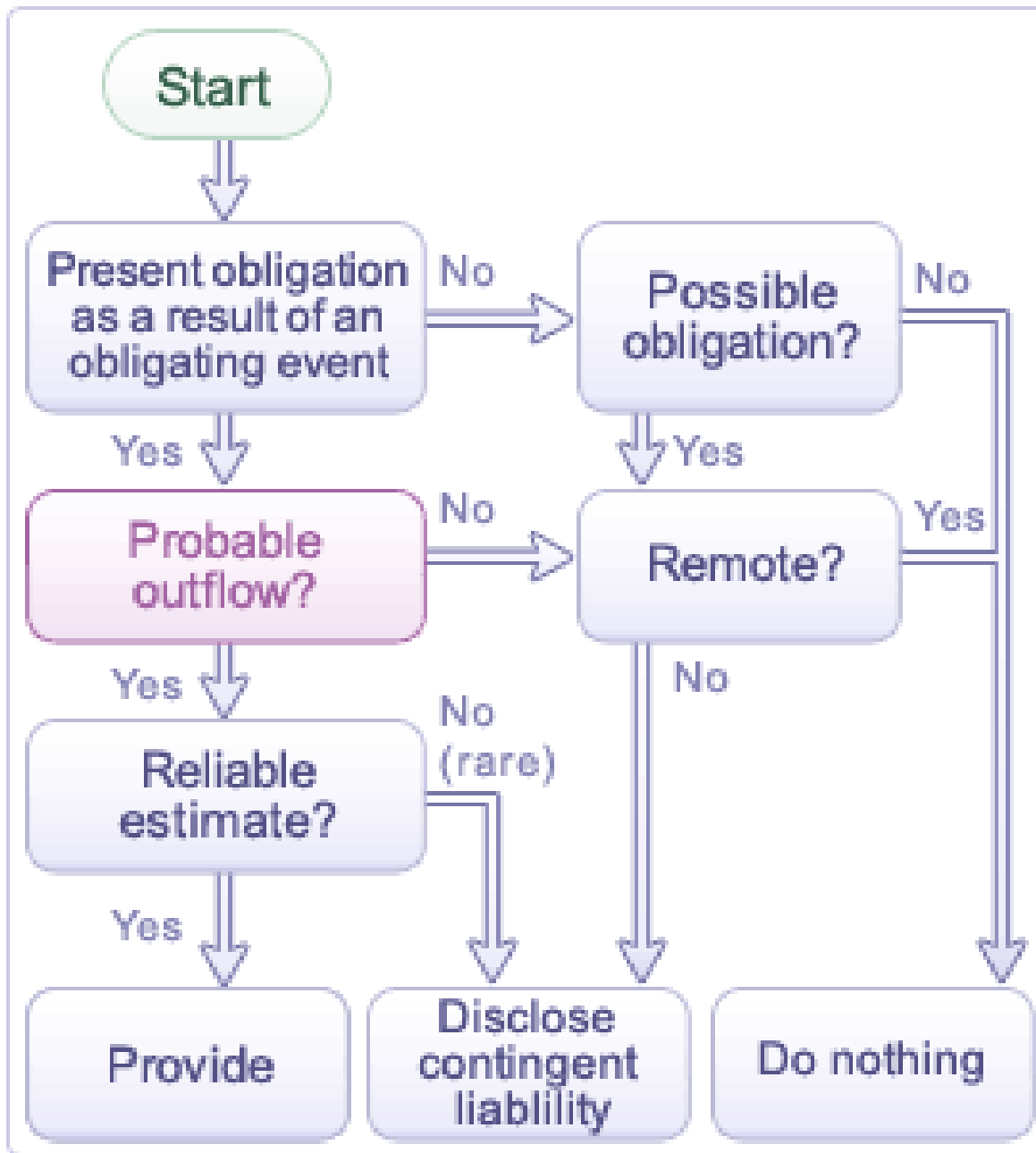
Contingent assets

- Contingent assets should not be recognised – but should be disclosed where an inflow of economic benefits is probable. When the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Summary of AS 29

Disclosures

- Reconciliation for each class of provision:
 - opening balance
 - additions
 - used (amounts charged against the provision)
 - unused amounts reversed
 - unwinding of the discount, or changes in discount rate
 - closing balance
- A prior year reconciliation is not required.
- For each class of provision, a brief description of:
 - nature
 - timing
 - uncertainties
 - assumptions
 - reimbursement, if any



Question 1

A constructive obligation to restructure arises only when an entity has:

Select one or more options and click **Submit**.

- a detailed formal plan for the restructuring.
- a detailed informal plan for the restructuring.
- raised a valid expectation with management that restructuring will be carried out.
- 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.

Q1

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Question 2

Just before the end of the reporting period an employer announced their intention to terminate the employment of a number of employees. The employer met with the trade union and presented the details of the terminations planned. However, the trade union indicated that they were unhappy with the terms and unlikely to agree to them. How should this event be accounted for in the employer's financial statements?

Select one option and click **Submit**.

- The employer has a detailed plan for the terminations and has created a constructive obligation through announcement of it and discussions with the trade union. Therefore, a provision should be recognised.
- As the employees through the trade union have not indicated acceptance of the plan, no constructive obligation exists, and no provision should be made
- A contingent liability should be disclosed, as the amount of the provision will be confirmed by acceptance of the terms by the employees and their trade union.

Q2

Just before the end of the reporting period an employer announced their intention to terminate the employment of a number of employees. The employer met with the trade union and presented the details of the terminations planned. However, the trade union indicated that they were unhappy with the terms and unlikely to agree to them. How should this event be accounted for in the employer's financial statements?

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- The employer has a detailed plan for the terminations and has created a constructive obligation through announcement of it and discussions with the trade union. Therefore, a provision should be recognised.
- As the employees through the trade union have not indicated acceptance of the plan, no constructive obligation exists, and no provision should be made
- A contingent liability should be disclosed, as the amount of the provision will be confirmed by acceptance of the terms by the employees and their trade union.

Question 3

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of €1 million would result. If major defects were detected in all products sold, repair costs of €4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75 % of the goods sold will have no defects, 20 % of the goods sold will have minor defects and 5 % of the goods sold will have major defects.

The expected value of the cost of repairs is:

Select one option and click **Submit**.

- €400,000
- €1 million
- €4 million
- €2,5million

-

Q3

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of €1 million would result. If major defects were detected in all products sold, repair costs of €4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75 % of the goods sold will have no defects, 20 % of the goods sold will have minor defects and 5 % of the goods sold will have major defects.

The expected value of the cost of repairs is:

Select one option and click **Submit**.

- €400,000
- €1 million
- €4 million
- €2,5million

Question 4

An entity has recognised a warranty provision in its statement of financial position. It has also taken out an insurance policy against returns from customers under the terms of the warranty offered. Proceeds from this insurance policy can be offset in the statement of comprehensive income against the warranty provision expense.

Is this statement true or false?

Select one option and click **Submit**.

- True
- False

Q4

An entity has recognised a warranty provision in its statement of financial position. It has also taken out an insurance policy against returns from customers under the terms of the warranty offered. Proceeds from this insurance policy can be offset in the statement of comprehensive income against the warranty provision expense.

Is this statement true or false?

Select one option and click **Submit**.

- True
- False

Question 5

Select the true statements with respect to contingent assets.

Contingent assets are:

Select one or more options and click **Submit**.

- not recognised in financial statements.
- recognised in the financial statements.
- disclosed in the financial statements if inflow is probable.
- never recognised in the financial statements.

Q5

Select the true statements with respect to contingent assets.

Contingent assets are:

Select one or more options and click **Submit**.

- not recognised in financial statements.
- recognised in the financial statements.
- disclosed in the financial statements if inflow is probable.
- never recognised in the financial statements.

Question 6

Which of the following statements is true?

Select one option and click **Submit**.

- A contingent asset can only be recognised if the inflow of economic benefits is virtually certain.
- Future operating losses meet definition of a liability if they can be measured reliably.
- An entity estimates a liability to be at least €5000 (90% chance) and €10,000 at most (10% chance). It should recognise a liability of €10,000.

Q6

Which of the following statements is true?

Select one option and click **Submit**.

- A contingent asset can only be recognised if the inflow of economic benefits is virtually certain.
- Future operating losses meet definition of a liability if they can be measured reliably.
- An entity estimates a liability to be at least €5000 (90% chance) and €10,000 at most (10% chance). It should recognise a liability of €10,000.

Question 7

Which statements need to be satisfied in order for a provision to be recognised?

Select one or more options and click **Submit**.

- An entity has a present obligation (legal or constructive) as a result of a past event
- An entity has a past obligation (legal or constructive) as a result of a past event
- It is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation
- A reliable estimate can be made of the amount of the obligation
- The amount of the obligation of the obligation is known

Q7

Which statements need to be satisfied in order for a provision to be recognised?

Select one or more options and click **Submit**.

- An entity has a present obligation (legal or constructive) as a result of a past event
- An entity has a past obligation (legal or constructive) as a result of a past event
- It is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation
- A reliable estimate can be made of the amount of the obligation
- The amount of the obligation of the obligation is known

Question 8

An entity is planning to install smoke filters as a result of new legislation, which was announced at the end of the reporting period. Which of the following statements are correct?

Select one or more options and click **Submit**.

- As a result of the new legislation, the entity has a constructive obligation. Therefore, a provision should be recognised.
- This is a future event, therefore there is no obligating event and no liability should be recognised
- This is a liability that will be confirmed by the occurrence of a future event. Therefore, a contingent liability should be disclosed.
- Any penalties arising because the entity fails to install the smoke filters or are late in installing the filters shall be provided for at the date that legislation is passed.

Q8

An entity is planning to install smoke filters as a result of new legislation, which was announced at the end of the reporting period. Which of the following statements are correct?

Select one or more options and click **Submit**.

- As a result of the new legislation, the entity has a constructive obligation. Therefore, a provision should be recognised.
- This is a future event, therefore there is no obligating event and no liability should be recognised
- This is a liability that will be confirmed by the occurrence of a future event. Therefore, a contingent liability should be disclosed.
- Any penalties arising because the entity fails to install the smoke filters or are late in installing the filters shall be provided for at the date that legislation is passed.

Question 9

A mining entity has damaged the environment through its past operations. At the end of the reporting period, legislation is passed requiring the entity to repair the damage. Is it appropriate for the entity to recognise a provision?

Select one or more options and click **Submit**.

- Yes, because the legislation creates a legal obligation
- Yes, because the legislation was passed at the end of the reporting period, and therefore there is a past event
- Yes, because the damage occurred in past, and hence there is a present obligation to repair the damage

Q9

A mining entity has damaged the environment through its past operations. At the end of the reporting period, legislation is passed requiring the entity to repair the damage. Is it appropriate for the entity to recognise a provision?

Select one or more options and click **Submit**.

- Yes, because the legislation creates a legal obligation
- Yes, because the legislation was passed at the end of the reporting period, and therefore there is a past event
- Yes, because the damage occurred in past, and hence there is a present obligation to repair the damage

Question 10

Which of the following statements are false?

Select one or more options and click **Submit**.

- An entity rents a property for its business operation. The property is rented over a period of ten years. The operation predicts it will be making losses for the first five years, but the overall contract is estimated to be profitable. This meets the definition of an onerous contract.
- An entity has abandoned a property that it was renting. It must continue to pay rent for the next three years due to the terms of the rental agreement, but there will be no economic benefits generated by the property. This meets the definition of an onerous contract.
- An entity that takes out insurance against a liability must set the asset off against the liability.

Q10

Which of the following statements are false?

Select one or more options and click **Submit**.

- An entity rents a property for its business operation. The property is rented over a period of ten years. The operation predicts it will be making losses for the first five years, but the overall contract is estimated to be profitable. This meets the definition of an onerous contract.
- An entity has abandoned a property that it was renting. It must continue to pay rent for the next three years due to the terms of the rental agreement, but there will be no economic benefits generated by the property. This meets the definition of an onerous contract.
- An entity that takes out insurance against a liability must set the asset off against the liability.

1. LIABILITY WITH PAYMENT LINKED TO FUTURE SALES

Background

Entity A faces a claim for an alleged infringement of intellectual property (IP) rights. On 31 December 20X1, in settlement of the claim, Entity A agrees to pay the claimant a fixed sum plus a variable amount calculated as 1 per cent of any revenue generated by Entity A over the next five years from sales of a specified product.

Question

At 31 December 20X1, should Entity A recognise a liability for the obligation to pay a variable amount on the basis of future sales?

1. LIABILITY WITH PAYMENT LINKED TO FUTURE SALES

Answer

It depends whether the variable amount to be paid based on future sales represents a settlement for use of the IP in the past or compensation for the future use by Entity A of the underlying IP:

- if the sales-linked feature is a **mechanism for determining the amount due for past use by Entity A of the IP** (plus any compensatory or punitive element), Entity A should recognise a liability under AS 30 *Financial Instruments: Recognition and Measurement* at 31 December 20X1; and
- if the sales-linked payments relate to **future use by Entity A of the IP**, the obligation arises as new sales are realised and represents an executory contract under AS 29. In such circumstances, Entity A should not recognise a liability for the variable amount to be paid based on future sales at 31 December 20X1, unless the executory contract is determined to be onerous.
- In practice, situations in which entities would recognise immediately a liability for the variable amount to be paid on the basis of future sales are expected to be rare.

2. LATE DELIVERY PENALTIES

Background

- In some circumstances, a late delivery penalty may be incurred when goods are not supplied by a specified delivery date. At the end of its reporting period, an entity may know that it will not be able to meet the delivery date for goods to be supplied in the next year.

Question

- Should the entity recognise a provision for the penalty that will be payable when, as is expected, the goods are delivered late?

2. LATE DELIVERY PENALTIES

Answer

- No. There is no past event because the late delivery of goods has not yet occurred. Consequently, there is neither a legal nor a constructive obligation to pay the penalty at the end of the current reporting period and no basis for recognising a provision for the penalty.
- However, if the remaining part of the contract has, as a whole, become onerous as a result of the penalty clause, a provision should be made for any overall loss expected to result.

3. LATE DELIVERY PENALTIES — EXAMPLE

- Entity A (which has a December year end) signed a firm sales contract with one of its major clients on 1 February 20X1. This contract specifies that 100 units of a product must be delivered before 1 February 20X2 at a fixed price of CU10 per unit. The costs of production are CU9 per unit. If the products are delivered more than 10 days late, the client will be given a discount of 50 per cent on each delayed product.
- When Entity A signed the contract, it had the ability and the intention to produce the 100 units on time. However, at the end of 20X1, it has only been able to deliver 80 units, and expects to deliver only 10 more before 1 February 20X2 due to manufacturing constraints. Therefore, at the end of the reporting period, Entity A expects to deliver 10 of the remaining 20 units at the discounted price of CU5 per unit.
- Total revenue from this contract will be CU950 $[(90 \times 10) + (10 \times 5)]$. Total costs will be CU900 (100×9) . Therefore, the overall contract is profitable. However, the situation at the end of the 20X1 reporting period is as follows:
 - Entity A has recognised CU800 revenue and CU720 costs (i.e. profit of CU80) in 20X1;
 - Entity A expects to deliver 10 units on time at a profit of CU10 $[(10 \times 10) - (10 \times 9)]$; and

3. LATE DELIVERY PENALTIES — EXAMPLE

- Entity A expects to deliver 10 units after the deadline at a loss of CU40 $[(10 \times 5) - (10 \times 9)]$.
- The remaining part of the contract is therefore onerous and a provision of CU30 (discounted if material) should be recognised to cover the potential loss arising from the outstanding obligations under the contract. If Entity A is able and expects to mitigate damages by purchasing suitable replacement products and delivering them prior to 1 February, the provision should be adjusted to reflect the expected economic loss anticipated to be incurred by Entity A.
- If Entity A had entered into this contract knowing that it would not be able to deliver on time, this would have been dealt with under the revenue recognition criteria. If, from the outset, Entity A expected to sell 100 units at an average price of CU9.50 ($CU950 \div 100$) per unit, then revenue of only CU9.50 would have been recognised for each unit sold (both in 20X1 and 20X2) and there would have been no need to consider a separate provision.

4. REPURCHASE AGREEMENTS — TRADE-IN RIGHT

Background

In order to facilitate vehicle sales, a motor dealer offers specified-price trade-in arrangements on vehicles for sale that give a customer the right to trade in his or her vehicle toward the purchase of a new vehicle. The trade-in may be exercisable by the customer at a specified point in time or during a specified period of time.

Question

Should the dealer recognise a provision for the cost of the guaranteed vehicle repurchases?

4. REPURCHASE AGREEMENTS — TRADE-IN RIGHT

Answer

- If the amount of trade-in credit for the new vehicle that the customer will receive upon exercise of a specified-price trade-in right is equal to or less than the estimated fair value of the vehicle at the trade-in date (determined on the date of the original sale of the vehicle subject to the specified-price trade-in right) and, in addition to that credit, if the customer is required to pay a significant incremental amount for the new vehicle at the trade-in date, then no revenue from the original sale of the vehicle should be allocated to the trade-in right and no provision should be recognised for the trade-in right at the time of the original sale.
- If the motor dealer subsequently determines, however, that the trade-in arrangement has become onerous, the motor dealer should recognise a provision for the onerous contract. In assessing whether, and to what extent, the trade-in arrangement has become onerous, the motor dealer should consider the net of:
 - any loss that may be incurred upon the customer's exercise of the specified-price trade-in right (i.e. the difference between the trade-in price and the resale value at that date of the vehicle traded in); and
 - any profit that may be expected on the sale of the new vehicle to the customer at the trade-in date.

5. EMPLOYMENT DISPUTES

Background

- An entity employs three professional seamen. Maritime law prescribes that registered professionals are paid a premium over unregistered professionals. The entity subsequently discovers that the professionals are not registered, and therefore, have been overpaid. The entity consequently reduces the salaries of these professionals who then take the matter to court. One employee wins the case and is awarded a CU70,000 retrenchment package. The other two lose on a technicality, but will appeal the decision. Lawyers are certain that the appeal will be successful.

Question

- What provision should be recognised?

5. EMPLOYMENT DISPUTES

Answer

- A provision should be recognised for the best estimate of the costs to settle the appeal. The past event is the underpayment of the employees (after it was thought they were overpaid) which occurred during the year. As a result of the court proceedings, a legal obligation to compensate the one employee exists in the current year (for CU70,000). With regard to the other two seamen, the past event is the constructive dismissal (i.e. the reduction in salaries) that occurred during the year. Because it is probable (more likely than not) that the entity will be found liable, a present obligation exists. It is probable that economic benefits will flow from the entity.

6. RECOGNITION OF CONSTRUCTIVE OBLIGATIONS ASSOCIATED WITH A CONSTRUCTION CONTRACT

Background

- Entity X is in the construction industry. It stores plant and machinery at its site, Site A, and transports certain plant and machinery (e.g. cranes) to a construction site (Site B), where it is in the process of constructing a hotel. At the end of construction, Entity X will be required to remove the crane from Site B and transport it back to Site A, or to a site of another contract.

Question

- Should a liability be recognised for the transporting of the crane back to site A?

6. RECOGNITION OF CONSTRUCTIVE OBLIGATIONS ASSOCIATED WITH A CONSTRUCTION CONTRACT

Answer

- Yes. A liability should be recognised for transporting the crane back to Site A. AS 7 Construction Contracts does not deal specifically with this type of provision, and so it falls within the scope of AS 29.
- It is only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) that are recognised as provisions.
- Because the crane cannot be left at Site B, Entity X has a constructive obligation to remove the crane. Therefore, Entity X should recognise a liability for the removal of the crane once it is installed on site B and measure that liability at the best estimate of the cost of transporting the crane back to Site A (or the next site at which it is required).

7. OBLIGATION TO RESTORE LEASED PROPERTY

Background

- Entity A is a lessee in a lease contract. As a condition of the lease and prior to return of the property to the lessor, Entity A is required to:
 - remove any leasehold improvements, such as additional internal walls or partitioning fitted by the lessee; and
 - repair the fabric of the building so that it is restored to its original condition at the date of inception of the lease, i.e. to make good any dilapidations.

Question

- When should Entity A recognise any provision in relation to restoration of the leased property?

7. OBLIGATION TO RESTORE LEASED PROPERTY

Answer

- If a lease agreement requires an item to be replaced if its standard falls below a specified level, no provision should be recognised until the point at which it is no longer possible for the entity to avoid replacing the item.
- Generally, it will not be appropriate to recognise a provision for restoring leased property on a straight-line basis over the lease term, because typically the obligation will not arise on a straight-line basis. For example, if a lease agreement requires carpets to be replaced or walls to be repainted at the end of the lease period, full provision for the associated cost will be required from the outset, because the outflow cannot be avoided.
- Typically, a provision will be recognised on a straight-line basis only when the associated costs are directly proportional to the length of time for which the associated asset has been used. This may be true for some elements of restoration relating to, for example, oil wells and landfill sites, but it is less common for property leases.
- Accordingly, Entity A should recognise a provision for the cost of removing leasehold improvements when those leasehold improvements are first made (e.g. when additional internal walls and partitioning are fitted). Entity A should only provide for repairs to the fabric of the building once it is no longer possible for Entity A to avoid making those repairs.

8. VOUCHERS ISSUED FOR NO CONSIDERATION

Background

- A reporting entity may, for no consideration, distribute vouchers that can be used, sometimes within a set period, to obtain discounts on the entity's products and/or a third party's products.

Question

- Should the entity recognise a provision in respect of the vouchers distributed?

8. VOUCHERS ISSUED FOR NO CONSIDERATION

Answer

Applying AS 29's recognition criteria, the questions to consider are as follows.

- Is there a present obligation? Generally, the answer will be yes. However, if the reporting entity reserves the right to terminate the scheme at any time, thus invalidating existing vouchers, then there may or may not be a constructive obligation. In the absence of evidence that schemes have been terminated (and existing vouchers invalidated) in the past, it should be presumed that an obligation exists.
- Is it probable that economic benefits will be transferred? If, after vouchers are deducted, the entity's products are still being sold at a profit, the answer will be no — in which case no provision should be recognised. To the extent that products will be sold at a loss, however, or that a third party will be reimbursed for discounts, there will be a transfer of economic benefits.
- Can a reliable estimate be made? The answer here should be presumed to be yes, but in making the estimate the entity should consider how many vouchers are expected to be used.
- In summary, if the criteria are met, a provision should be recognised for the best estimate of the cost to the entity (which may not be the face value of the discounts). The entity will need to form a view as to how many vouchers are expected to be used and should also consider whether discounting is appropriate.

9. OBLIGATION FOR FUTURE COSTS — MAJOR REFIT AND REPAIR COSTS

Question

- Ships and aircraft are required to undergo major work at regular intervals due to maritime and aviation law. Should an entity, which recognises these ships and aircraft as assets, accrue an obligation for these future costs?

Answer

- No. There is no present obligation created by the legal requirement to do the major work until the requisite number of hours or days have been completed. The cost of the major work is not recognised because, at the end of the reporting period, no obligation to undergo such major work exists independently of the entity's future actions — the entity could avoid the future expenditure by its future actions, for example by selling the ship or aircraft.

10. LEASE OF AIRCRAFT — EXAMPLE

- Under some operating leases, the lessee is required to incur periodic charges for maintenance of the leased asset or to make good dilapidations or other damage occurring during the rental period. Because the lease is a legal contract, it may give rise to legal obligations. Accordingly, the principles of AS 29, which generally preclude the recognition of provisions for repairs and maintenance, do not preclude the recognition of such liabilities in a lease once the event giving rise to the obligation under the lease has occurred.
- For example, an entity leases an aircraft under an operating lease. The aircraft has to undergo an expensive 'C check' after every 2,400 flying hours.
- The requirement to perform a 'C check' does not give rise to a present obligation at the time the lease is signed because, until 2,400 hours have been flown, no obligation exists independently of the entity's future actions. Even the intention to incur the cost of a 'C check' depends on the entity deciding to continue flying the aircraft. Therefore, no provision should be recognised for a future 'C check'. The cost of each successive 'C check' will instead be capitalised when it is incurred and amortised over the period to the next 'C check'.

10. LEASE OF AIRCRAFT — EXAMPLE

- This leaves the question of the condition in which the aircraft must be returned to the lessor at the end of the lease and of whether this creates a present obligation, and thus the requirement for a provision, at the time the lease is signed. The answer depends on what the lease terms state will happen when the aircraft is returned at the end of the lease. If no final 'C check' is required (i.e. in the final period, the client can use the aircraft for up to 2,399 flying hours and then return it without bearing any cost), no provision should be recognised because there is no legal obligation.
- If a 'C check' is required at the end of the lease, irrespective of how many hours have been flown, full provision for the cost should be recognised at the start of the lease. The costs should be carried forward and written off over the shorter of the next 2,400 flying hours and the number of flying hours to the end of the lease — and similarly each time a 'C check' is carried out.
- If, on returning the aircraft, the entity must make a payment towards the 'C check' which is in proportion to the number of hours flown (e.g. 75 per cent of the cost of a 'C check' for 1,800 hours flown), then an obligation is created as the aircraft is used. It will be appropriate to build up a provision based on the number of hours flown.

11. RECOGNITION OF REIMBURSEMENT EXPECTED FROM INSURANCE COMPANY

Background

- An entity has a high probability of losing a lawsuit in which it is the defendant. The entity's insurance company is expected to cover any loss incurred.

Question

- What amounts, if any, should the entity recognise in its statement of financial position in respect of the anticipated loss and reimbursement?

11. RECOGNITION OF REIMBURSEMENT EXPECTED FROM INSURANCE COMPANY

Answer

- The outflow of resources expected on the loss of the lawsuit and the amounts expected to be recovered from the insurance company arise from the same past event.
- When the conditions of AS 29 are met, the entity should recognise a liability for the expected outflow of resources, measured at the best estimate of the expenditure required to settle the obligation at the end of the reporting period as stated in AS 29.
- In respect of the expected recovery from the insurance company, the entity should assess the effectiveness of its insurance policy. Under AS 29, it should recognise the amount expected to be reimbursed (as a separate asset) when, and only when, it is virtually certain that the claim will be received (i.e. unless there is doubt regarding the insurance claim).
- The amount recognised for the reimbursement should not exceed the amount of the provision.

12A. RECOGNITION AND MEASUREMENT OF ONEROUS CONTRACTS

Background

- Entity A has entered into a contract with Entity B to supply goods for a fixed price of CU100. Because of price inflation, Entity A's expenditure to meet its obligations under the contract is expected to be CU120. No other benefits are expected under the contract. Therefore, the contract is considered to be onerous, and a provision should be recognised. Entity A estimates that any compensation or penalties arising from failure to fulfill the contract are equal to the cost of fulfilling the contract (i.e. CU120).

Question 1

- Should the provision recognised by Entity A be the entire cost of fulfilling the contract (CU120) or only the expected loss (CU20)?

12A. RECOGNITION AND MEASUREMENT OF ONEROUS CONTRACTS

Answer 1

- Entity A should recognise a provision for the onerous contract equal to the expected loss of CU20.
- AS 29 defines an onerous contract as “a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it”. AS 29 further states that “[t]he 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 fulfill it” (emphasis added).
- Because AS 29 refers to the net cost rather than the gross cost associated with the contract, the provision for the onerous contract should reflect the costs required to fulfill the contract net of any income that the entity will receive as a consequence of fulfilling the contract.

12B. RECOGNITION AND MEASUREMENT OF ONEROUS CONTRACTS

Background

- Entity A has entered into a contract with Entity B to supply goods for a fixed price of CU100. Because of price inflation, Entity A's expenditure to meet its obligations under the contract is expected to be CU120. No other benefits are expected under the contract. Therefore, the contract is considered to be onerous, and a provision should be recognised. Entity A estimates that any compensation or penalties arising from failure to fulfill the contract are equal to the cost of fulfilling the contract (i.e. CU120).

Question 2

At the end of the reporting period, Entity A has commenced negotiations with Entity B with a view to increasing the price at which the goods are supplied under the contract. Entity A expects that Entity B will be willing to agree to such a price increase so as to avoid Entity A ceasing to trade as a result of the losses incurred under the contract (and, consequently, cutting off the source of supply of goods necessary for Entity B's own business).

- Should the potential renegotiation of the supply contract between Entity A and Entity B be reflected in the amount of provision recognised for the onerous contract?

12B. RECOGNITION AND MEASUREMENT OF ONEROUS CONTRACTS

Answer 2

- No. The onerous contract should be measured based on the contractual terms in existence at the end of the reporting period because that is Entity A's 'present obligation' required to be recognised and measured in accordance with AS 29. Any future amendment to the terms of the contract would be a change in the obligation resulting in remeasurement of the provision when the amendment occurs.
- AS 29 states that "future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur". However, this reference to future events is not to changes in the underlying obligation, but to those future events that are factors in estimating the costs of meeting a present obligation (e.g. developments in the technology used to clean up a site [AS 29]) or in assessing the extent to which a present contractual obligation is onerous (e.g. an expectation of subleasing a vacant property).

13. LEASE TERMINATION

Background

- An entity has developed a detailed formal plan for restructuring a business, and has announced the key features of the restructuring to all affected by it in a manner that meets the criteria of AS 29. As part of the restructuring, the entity has entered into an oral agreement (i.e. a commitment has been established) with the landlord to terminate a lease and pay a settlement fee of CU1 million to the landlord. The settlement fee represents a direct cost resulting from the restructuring. The entity does not expect to be able to sublet the property; therefore, the CU1 million represents the minimum expected obligation.

Question

- Should a provision be recognised for the settlement fee to the landlord?

13. LEASE TERMINATION

Answer

- Yes. A provision should be recognised for the CU1 million settlement fee for the lease because a valid expectation has been created between the lessor and lessee that the lease will be terminated.
- The entity has a constructive restructuring obligation because it has publicly announced the plan to restructure. Such an announcement gives rise to valid expectations in other parties (e.g. the lessor) that the entity will carry out the restructuring, which includes the termination of the lease.

14. IDENTIFICATION OF EMPLOYEES TO BE TERMINATED UNDER A RESTRUCTURING PLAN

Background

- Under AS 29, the two principal requirements for the recognition of a provision for a restructuring are that the entity (a) "has a detailed formal plan" and (b) "has raised a valid expectation in those affected [that the plan will be carried out,] by starting to implement that plan or announcing its main features to those affected by it".

Question

- To meet the criteria for recognition as a provision, is it necessary that a plan for restructuring specifically identify which individual employees will be terminated under the plan?

14. IDENTIFICATION OF EMPLOYEES TO BE TERMINATED UNDER A RESTRUCTURING PLAN

Answer

- No. AS 29 requires that the detailed formal plan must identify the location, function and approximate number of employees who will be compensated for terminating their services. Generally, it is not necessary for the plan to be so detailed that it identifies which individual employees will be leaving. However, it must be sufficiently detailed that those employees in the employee groups affected by the restructuring plan have a valid expectation that either they or their colleagues in the group will be affected.

15. ENTITY IS DEMONSTRABLY COMMITTED TO ONLY PART OF A RESTRUCTURING PLAN

Background

- AS 29 states that a constructive obligation to restructure arises only when the entity (a) "has a detailed formal plan" and (b) "has raised a valid expectation in those affected [that the plan will be carried out,] by starting to implement that plan or announcing its main features to those affected by it".

Question

- To meet the criteria for recognition as a provision, is it necessary that the entity be demonstrably committed to all of the restructuring plan?

15. ENTITY IS DEMONSTRABLY COMMITTED TO ONLY PART OF A RESTRUCTURING PLAN

Answer

- No. AS 29 clarifies that, for a plan to be sufficient to give rise to a constructive obligation when it is communicated to those affected by it, implementation of the plan should be planned to begin as soon as possible and to be completed within a timeframe that makes significant change to the plan unlikely. When either there is a long delay before commencement, or execution of the plan will take an unreasonably long time, the timeframe allows opportunities for the plan to be changed. Thus, it is unlikely that the reporting entity has raised a valid expectation that it is sufficiently committed to the restructuring.
- However, when a restructuring plan will take quite a long time to be completed, it is possible that the entity may be demonstrably committed to earlier actions in the plan but not to later actions in the plan. In such circumstances, a provision should be recognised only for those actions to which the entity is committed, i.e. the earlier actions in the restructuring plan.

16. ENTITY TO HAVE RAISED A VALID EXPECTATION IN THOSE AFFECTED BY A RESTRUCTURING PLAN AT THE END OF THE PERIOD

Background

- Under AS 29, the two principal requirements for the recognition of a provision for a restructuring are that the entity (a) "has a detailed formal plan" and (b) "has raised a valid expectation in those affected [that the plan will be carried out,] by starting to implement that plan or announcing its main features to those affected by it".

Question

- For the purposes of AS 29, does the requirement for the existence of a valid expectation in those affected relate to the situation at the end of the reporting period?

16. ENTITY TO HAVE RAISED A VALID EXPECTATION IN THOSE AFFECTED BY A RESTRUCTURING PLAN AT THE END OF THE PERIOD

Answer

- Yes. The expectations of those affected by the plan must have been raised at or before the end of the reporting period.
- The fact that implementation has commenced by the date that the financial statements are authorised for issue does not by itself provide evidence that a present obligation existed at the end of the reporting period.

17. VACANT PROPERTY

Background

- Company X entered into an operating lease over a property several years ago. The property is now surplus to requirements and Company X has vacated it. The lease has three years to run with an associated expense of CU10,000 per year.
- Company X believes it may be able to find a tenant to take a sublease of the property, but that it might only receive CU8,000 per year from the sublease. Alternatively, the landlord is prepared to terminate the lease and forgive the future rentals of CU30,000, if Company X makes a termination payment of CU5,500.

Question

- What, if any, provision should Company X recognise in relation to the operating lease?

17. VACANT PROPERTY

Answer

- Because the property has been vacated, and the continuing rentals are not expected to be recoverable from subleasing the property, a provision should be recognised. The provision should represent the best estimate of the expenditure required to settle the obligation at the end of the reporting period. If Company X subleases the property, it expects to pay CU30,000 in lease rentals and receive CU24,000 in sublease rentals, which would leave a deficit of CU6,000 to be provided. However, in this case, the amount the landlord would accept to terminate the lease is CU5,500, which is lower. Accordingly, Entity X should recognise an onerous lease provision of CU5,500, irrespective of whether it intends to terminate the lease or enter into a sublease.

Thank you