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IAS® Standard 37 Provisions, Contingent Liabilities and Contingent Assets

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CASE STUDY - IAS 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Introduction

Many entities have liabilities that are characterised by uncertainty in terms of timing, probability of occurrence, and value. Estimates and professional judgement are employed to determine if and when these are recognized as liabilities in the statement of financial position, or disclosures made in the notes to the financial statements suffice for offering useful information to users.

The aim of this case study is to discuss the consequences of liabilities that are characterised by uncertainty in terms of timing, probability of occurrence, and value, on the entities' financial position. You are an accountant working with Oil Terminal Ltd., a multinational corporation active in the oil and gas industry. Despite its best efforts, it is inevitable for the entity to avoid polluting the environment, given its activity. However, it is not always obvious if and to what extent the entity must ensure that the sites are restored. This also depends on the laws in place in various jurisdictions.

The Case Information

Oil Terminal Ltd. is based in and listed on the stock exchange of Developedland, a well-developed country, and it operates two sites in this jurisdiction. Developedland has strong laws in place demanding entities to restore the damaged environment. Moreover, the entity's slogan is: "We care for and protect Developedland's environment". It is expected that the restoration costs of the environment after the production ends amount to CU25,000. A provision of CU15,000 has been recognized in prior years in this respect.

Moreover, Oil Terminal Ltd. has subsidiaries and operates extraction sites in three developing countries, i.e., Eastland, Southland and Northland. Eastland has no law obliging companies to restore the sites once they were polluted. However, it is virtually certain that a law will be passed early next year obliging companies to restore their sites. The estimated costs to restore the sites are CU6,000.

Southland has no law in place requiring companies to protect the environment, but several NGOs push entities to be more responsible. Having a good image in this respect helps attract more clients in this country. Therefore, the subsidiary in Southland publicly announced that it will restore the environment. The estimated costs are between CU8,000 and CU10,000.

The subsidiary in Northland has just started its activity. It is the first operation of the Oil Terminal entity in that region. Northland has a law in place requiring entities to restore the environment. However, the managers of the Northland's subsidiary claim that they cannot estimate the future costs of restoring the environment, given that they just started the operations there.

The forecast duration of the operations is between 10 and 15 years in all sites. The indicated amounts of the costs are not discounted.

Discussion Questions

1) Discuss if a provision should be recognised in each country, and for what amount.
2) What is the time value of money implication for the provisions to be recognised?

SOLUTION OF CASE STUDY - IAS 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

1) In accordance with IAS 37, provisions are recognised when:

a) an entity 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 will be required to settle the obligation; and

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

If all or any of these conditions are not met, no provision shall be recognised. The value of the provision reflects the liability at the end of the year.

Oil Terminal has both a legal and a constructive obligation to restore the environment in Developedland. Given that its activities pollute the environment, it is probable to incur an outflow of resources to settle the obligation. The liability was estimated at CU25,000. This is the amount to be reported in the statement of financial position at the end of the period. Given that a provision of CU15,000 is already recognised, an adjustment (increase in provisions) will be recorded for CU10,000.

Eastland will certainly have a law; therefore, Oil Terminal's subsidiary is under the legal obligation to restore the environment. Given that its activities pollute the environment, it is probable to incur an outflow of resources to settle the obligation. The liability was estimated at CU6,000. This is the amount to be reported in the statement of financial position at the end of the period (therefore, at the end of the year an expense and a provision of CU6,000 are recognised).

The subsidiary in Southland does not have any legal obligation to restore the environment, but it has a constructive one, given its public statement to that effect. Given that its activities pollute the environment, it is probable to incur an outflow of resources to settle the obligation. The liability was estimated between CU8,000 and CU10,000. The liability needs to be measured at the most likely outcome. Based on the experts' opinion, an amount between CU8,000 and CU10,000, reflecting the most likely outcome, will be reported in the statement of financial position at the end of the period (and an expense with the same amount will be reported in the statement of profit or loss).

The subsidiary in Northland has a legal obligation and a probability of outflows of resources. However, given that it just started its activity, managers claim that they do not have enough data to reliably estimate the value of the provision. Therefore, a provision cannot be recognised, but the entity must disclose (in the notes) a contingent liability.

2) When the time value of money differs significantly, provisions must be measured at discounted values. This is particularly the case when the liabilities will be settled after a long period (of several years), which is the case here. Therefore, each of the provisions recognised must be discounted, taking into consideration the appropriate discount rate for each country. Discounting provisions will result in lower amounts reported in liabilities at first, and in a yearly increase in liability and a yearly financial expense to recognise the yearly financial cost in the statement of profit or loss.