CHAPTER 2

Key accounting and financial reporting issues- Provisions and contingent liabilities

Disclosures of provisions and contingent liabilities are sometimes restricted to a short note towards the back of the financial statements with a brief comment in the management report. However, even when a provision is not significant in amount, the circumstances to which it relates can be of great significance to investors owing to the levels of estimation uncertainty, judgements involved, or the forward-looking information it can provide about a company's exposures. The circumstances giving rise to the provisions and contingent liabilities are likely to have an impact over medium to long-term, such as climate change and other environmental obligations, or significant to the assessment of future business performance, for example, onerous contracts and regulatory penalties or compensation. Hence investors should be provided with high-quality disclosures pertaining to this area.

With this background, in this article, we will highlight some of the key areas that regulators have highlighted and provided improvement points in the area of **provisions, contingent liabilities and contingent assets**. We have also provided illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC) and illustrative disclosures issued by KPMG IFRG Limited in 2023.

Source

While preparing this article, we have referred to:

- The recent observations of the National Financial Reporting Authority (NFRA),
- The Ind AS observations of the Financial Reporting Review Board (FRRB) of the Institute of Chartered Accountants of India (ICAI),
- The report- Annual Review of Corporate Reporting (2022/23) issued by the Financial Reporting Council, and
- Recent ESMA[1] enforcement directions

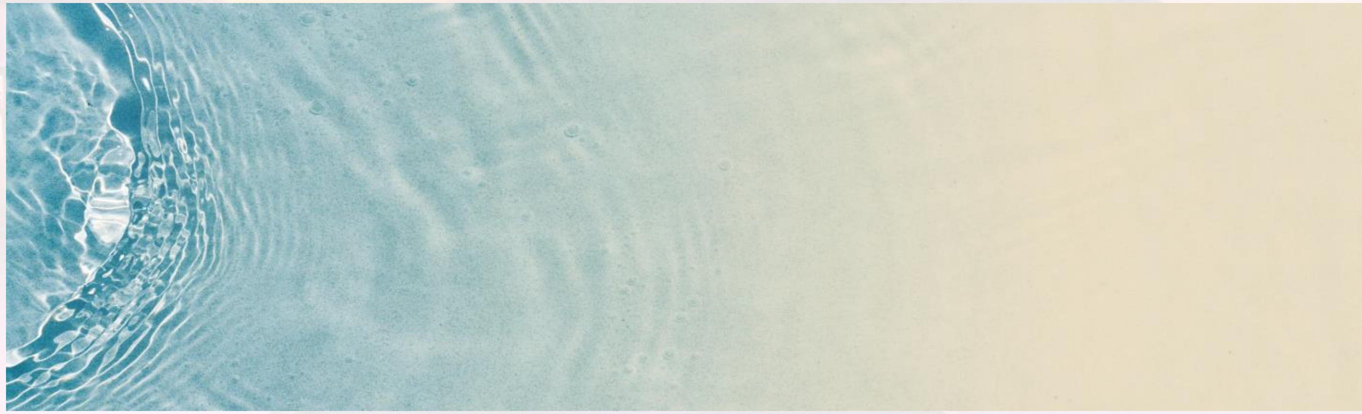
1. European Securities and Markets Authority.
2. Up to 31 December 2022, IAS 1, Presentation of Financial Statements, required companies to disclose significant accounting policies. With effect from 1 January 2023, companies are required to disclose material accounting policy information. An entity should evaluate to determine its 'material' accounting policy information as per amendment in IAS 1.

Key issues and recommendations pertaining to provisions, contingent liabilities and contingent assets

Some of the key issues and recommendations pertaining to provisions, contingent liabilities and contingent assets is given below:

Accounting policies

As per IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, accounting policies are the specific principles, bases, conventions, rules and practices that an entity applies in preparing and presenting financial statements. Companies are required to disclose material accounting policy information[2] in the financial statements. While doing so, it should be ensured that concise and entity specific descriptions of the accounting policies adopted in respect of provisions and contingencies are disclosed.



Example of an accounting policy where a company disclosed a general accounting policy for provisions, but then provided more specific information about certain classes of provisions which are carried in the books of account

Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The unwinding of the discount is recognised as finance cost.

Warranties	A provision for warranties is recognised when the underlying products or services are sold, based on historical warranty data and a weighting of possible outcomes against their associated probabilities
Restructuring	A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring either has commenced or has been announced publicly. Future operating losses are not provided for
Site restoration	In accordance with the Group's published environmental policy and applicable legal requirements, a provision for site restoration in respect of contaminated land, and the related expense, is recognised when the land is contaminated
Onerous contracts	A provision for onerous contracts is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract, which is determined based on the incremental costs of fulfilling the obligation under the contract and an allocation of other costs directly related to fulfilling the contract. Before a provision is established, the Group recognises any impairment loss on the assets associated with the contract

(Source: Illustrative disclosures: Guide to annual financial statements issued by KPMG IFRG Limited, in September 2023)

Nature and timing of provisions

IAS 37 *inter alia* requires companies to provide a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.

In this regard, it is expected that all relevant information pertaining to provisions should be incorporated within the note on provisions or given by cross reference[3]. Duplication of information should be kept at a minimum. Further, the labelling of the provision should be clear, as that would allow the disclosure to be relatively brief, while still communicating the relevant information. For example, labels such as- dilapidation provisions arising from the terms of a lease contract or a constructive obligation arising from previously announced plans to restructure the company's operations explain the nature of the obligation. However, greater detail may be required for unusual provisions to explain why there is a constructive or a legal obligation.

In addition to the nature of each material exposure, the timeframe over which it is expected to crystallise and the basis for determining the best estimate of the probable or possible outflow should also be disclosed. While providing disclosures of the expected timing of the provision, the following should be considered:

- Where the disclosures depend on other information, for example, the duration of a related contract term, this should be quantified
- Where the provision is large and covers a number of individual exposures (e.g. remediation at several sites or phases of decommissioning), more granular information about the timing should be provided. This is particularly relevant for long-term provisions.

3. Reliance should not be placed on information included in other documents or previous annual reports

An example of disclosure of the nature of a short-term and long-term provision

Provision for warranties *(generally a short-term provision)*

The provision for warranties relates mainly to paper sold during 2022 and 2023. The provision has been estimated based on historical warranty data associated with similar products and services. The Group expects to settle the majority of the liability over the next year. An expected reimbursement of warranty expense incurred of EURXX thousand has been included in 'other trade receivables' (refer note XX) following a supplier accepting responsibility for the defective products

Provision for site restoration *(generally a long-term provision)*

Under Romanian law, the Group's subsidiary in Romania is required to restore the contaminated land to its original condition before the end of 2025. During 2023, the Group provided EURXX thousand for this purpose.

Because of the long-term nature of the liability, the greatest uncertainty in estimating the provision is the costs that will be incurred. In particular, the Group has assumed that the site will be restored using technology and materials that are currently available. The Group has been provided with a range of possible reasonably possible outcomes for the total cost, which range from EUR500 thousand to EUR700 thousand, reflecting different assumptions about pricing of the individual components of the cost. The provision has been calculated using a discount rate of 5.9 per cent, which is the risk-free rate in Romania. The rehabilitation is expected to occur in the next two to three years.

(Source: Illustrative disclosures: Guide to annual financial statements issued by KPMG IFRG Limited, in September 2023)

Contingent liability

IAS 37 has prescribed certain disclosures for contingent liabilities- which includes the following for each class of contingent liability:

- A brief description of the nature of the contingent liability,
- Where practicable, an estimate of its financial effect,
- An indication of the uncertainties relating to the amount or timing of outflow and possibility of any reimbursement.

Quantitative information about expected or maximum exposures to contingent liabilities should be disclosed, and where it is not practicable to provide an estimate of the financial effect, a clear and justified statement to that effect should be made. Negative confirmations can be helpful where users may otherwise expect the company to report an exposure.

Example disclosure 1- Disclosure, where the expected maximum exposure of the company has been disclosed. The disclosure also explains why it is not possible to determine the best estimate and expected timing of such outflows

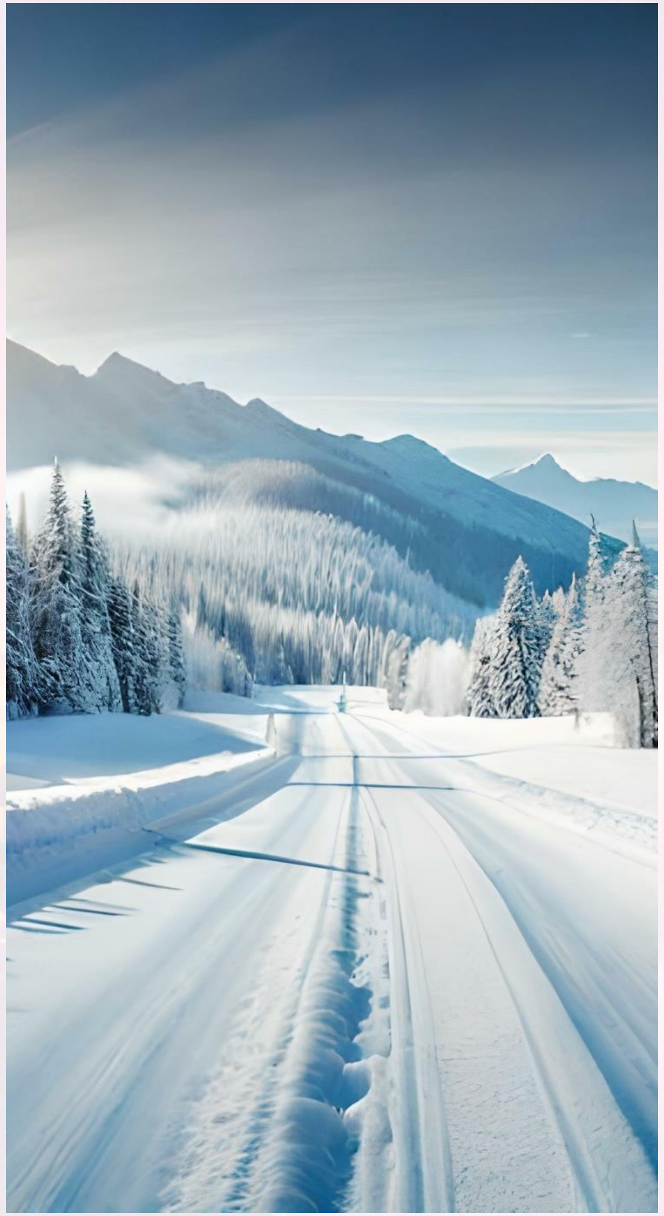
There is an ongoing criminal investigation into the production of thermally cleaned soil at [Company]. This may or may not result in a prosecution and if so, we expect such a process will likely take many years, should it proceed. [Company] will defend its conduct strongly in such an event. Given that it is not even clear whether or what charges might be brought in the criminal case and the charge is expected to be lower than EUR1m we do not consider it appropriate at this stage to provide for this. Given these uncertainties, it cannot be ruled out that the outcome of the criminal investigation or the topic it concerns could result in liability for damages resulting from third party claims in the future.

(Source: Thematic review: IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’, issued by the FRC in October 2021)

Example disclosure 2- Disclosure, where the expected maximum exposure of the company and the amount recognised as a provision has been disclosed. The expected timeframe for resolution of the uncertainty and when the resulting outflow may occur has also been explained

Renewi has provided EUR15m based on legal advice which represents management’s best estimate of the most likely outcome. It is noted that the potential maximum claim is €58m (excluding compound interest currently amounting to EUR5m), and therefore there is a potential further liability should the Group be wholly unsuccessful in its defence. A ruling from the European Commission is expected during FY22 but no monies would likely become payable until FY23.

(Source: Thematic review: IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’, issued by the FRC in October 2021)



Uncertainty in computation

As per IAS 37, the use of estimates is an essential part of computing provisions, as by their very nature and, provisions involve a high degree of uncertainty than many other items in the financial statements. While computing provisions, there could be uncertainty in the amount of economic outflow, uncertainty in timing of the outflow[4] or uncertainty in discount rates. These need to be appropriately disclosed in the financial statements.

Example disclosure 1: Uncertainty in amount of economic outflow

This disclosure explained that estimated outflow remained materially uncertain, owing to the number of cases not yet determined by the skilled person, and provided a range of possible outcomes.

A further assumption which has an impact upon the provision is the timing of benefits taken. The uncertainty regarding the timing of benefits taken by each member for the cases not yet determined by the skilled person has a potentially material future impact upon the provision. The range of outcomes for the provision, including anticipated costs, varies from GBP25 million to GBP36 million at each extremity of possible timing of benefits taken.

(Source: Thematic review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', issued by the FRC in October 2021)

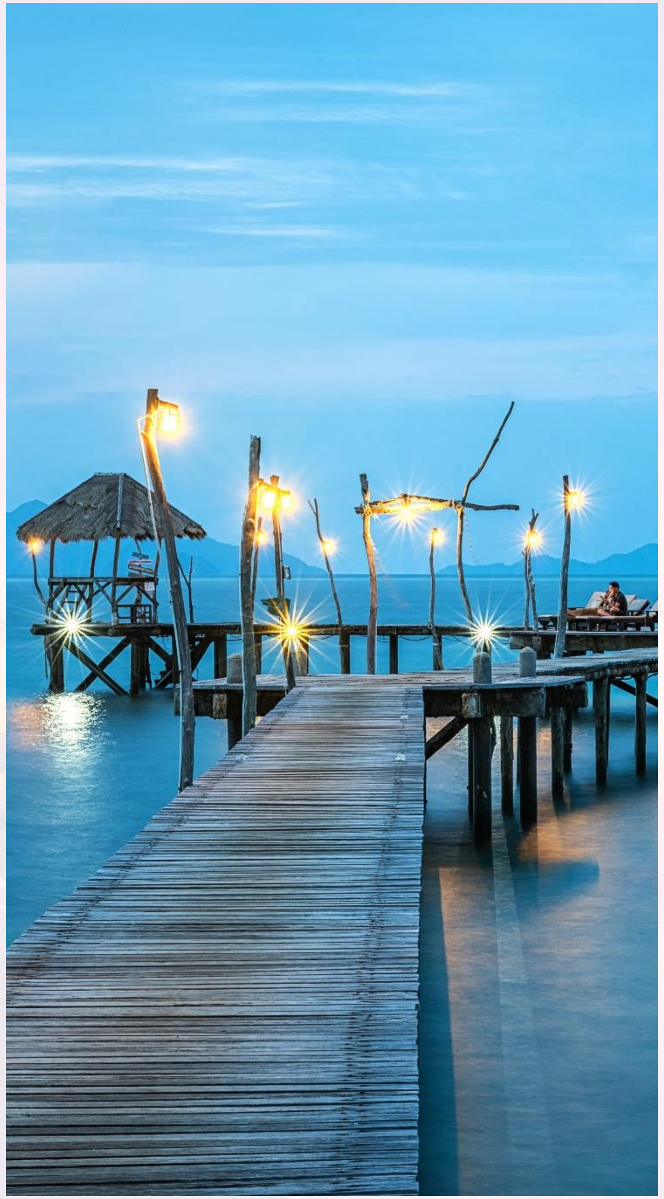
IAS 37 does not specifically require the disclosure of discount rates used to calculate the present value of estimated future outflows. However, regulators expect companies to disclose the discount rate and how it is calculated, where the effect of discounting is material. This disclosure aids comparability from one period to the next and across companies.

Example disclosure 2: How estimation of discount rate is affected by the key currencies in which the company transacted

… the present value of [restoration] provisions has been calculated using discount rates of between 4.5 per cent and 4.9 per cent in Kazakhstan … and 6.4 per cent in Kyrgyzstan … Management estimates the discount rate for its provisions in Kazakhstan based on sovereign bond yields denominated in US dollars adjusted for the differential inflation between the Tenge and the US dollar, which is lower in the long term.

Management has not calculated its provisions using Kazakhstan sovereign bond yields denominated in Tenge, as these bonds have largely been purchased by local institutions and there are limited bonds with maturities which are comparable to the remaining life of each mine.[5]

(Source: Thematic review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', issued by the FRC in October 2021)



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4. The uncertainty in timing of outflow could have a material effect on:
   - the amount payable due to cost inflation;
   - the present value of outflows, through discounting; and
   - presentation of the provision (or parts of it) as a current or non current liability in the statement of financial position.
5. Companies should consider whether their disclosure explains each of the following matters, where this is material to understand the estimation uncertainty:
   - how the discount rate has been determined from benchmark rates, and what adjustment (if any) has been applied for cash flow risk, especially where the risk profile (and hence rate adjustment) has changed from the prior period;
   - the use of different rates for different provisions and how this relates to the risks inherent in each liability;
   - use of a real discount rate where projected cash flows have not been increased for inflation or a nominal rate where inflation has been applied in forecasting; and
   - why an adjustment (if made) for own credit risk is justified in the specific context of the liability

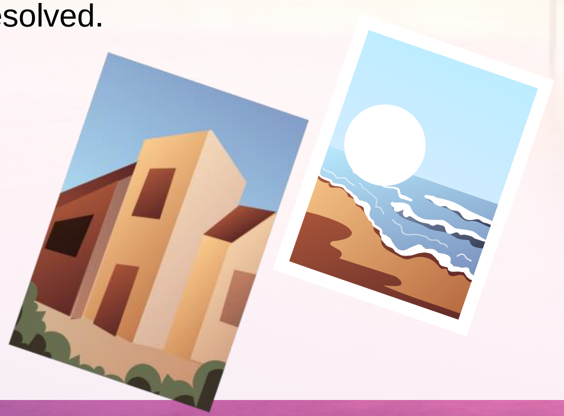
Significant judgements and sources of estimation uncertainty

IAS 1 requires companies to disclose information about the assumptions it makes about the future , and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. This disclosure focuses on short-term effects of uncertainty and complements the requirements of IAS 37 (which requires companies to indicate uncertainties about the amount or timing of outflows of provisions). Companies may deal appropriately with these two aspects of uncertainty disclosures in a single note.

Companies should take care not to omit relevant disclosure about estimation uncertainty when reporting the significant judgements made in preparing their financial statements.

IAS 1 sets out the kinds of information that enable users to understand management's assumptions and the effect of estimation uncertainty as follows:

- The nature of the assumption or other estimation uncertainty;
- The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
- The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.



Example disclosure: Management's assumptions and key sources of estimation uncertainty for provisions

Provisions for restoration and decommissioning obligations are made based on the best estimate of the likely committed cash outflow. Management seek specialist input from third party experts to estimate the cost to perform necessary remediation work at the reporting date. These experts undertake site visits in years where scoping identifies there is a change in operations in the year which could suggest a change in these estimates, or at sites that have not been visited recently*. Desktop reviews are undertaken to inform the estimates for other sites. If the cost estimates increased by 10 per cent the value of provisions could change by GBP1.2m. The useful lives of quarrying sites are based on the estimated mineral reserve remaining and manufacturing facilities linked to the useful life of site property, plant and equipment. Changes to these useful lives do not have a significant impact on the provision[#].

The estimation of inflation and discount rates is also considered to be judgemental and can have a significant impact on net present value. Management reference information from the Bank of England when making such estimates. If the discount or inflation rate were changed and the spread between them increased by 1 per cent the value of provisions could change by GBP2.5m[$].

Notes:

* : This company clearly sets out its methodology for estimating the outflow, using current costs as determined by third party experts from site visits where there is likely to be greater uncertainty owing to changes in operations or passage of time.

#: Sensitivity disclosure addressed changes in estimated costs and the spread between the discount rate and inflation.

The comment on useful lives of quarrying sites and of property, plant and equipment at manufacturing facilities is informative even though changes to these lives do not have a significant effect. The disclosure provides a reasonable indication that the expected timing of outflows, estimated from current costs, is not a critical source of uncertainty compared to the absolute amounts estimated or the rate at which future outflows are discounted to present value.

$: This disclosure noted the source for the 'time value of money' (risk free) component of the discount rate. The accounting policy for provisions explained that the discount rate is adjusted for risks specific to the liability

(Source: Thematic review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', issued by the FRC in October 2021)

Reimbursement asset

As per IAS 37, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement would be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement would be treated as a separate asset.

It is to be noted that the amount recognised for the reimbursement should not exceed the amount of the provision.

Example disclosure: Overall net position of provision after factoring in the reimbursement asset.

US asbestos-related provision	2020 (million pounds)	2019 (million pounds)
Gross provision	72.7	50.6
Effect of discounting	(8.2)	(6.2)
Discounted US asbestos-related provision	64.5	44.4
Insurance asset	52.4	43.4
Net US asbestos-related liability	12.1	1.0

The net provision and insurance asset are presented in the accounts as follows

	2020 (million pounds)	2019 (million pounds)
Provisions – current	7.2	7.1
Provisions – non-current	57.3	37.3
Trade & other receivables	7.2	7.0
Long-term receivables	45.2	36.4

(Source: Thematic review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', issued by the FRC in October 2021)