

Provisions, or the principle of prudence



This newsletter dealing with the provisions of the Act on Accounting highlights issues that may arise with respect to provisions.

Provisions must be recognised for payment obligations to third parties derived from past or present transactions or contracts. In this respect, it must be defined which events generate the obligation and when these events occur. Based on the Act on Accounting, this type of obligation may include warranty obligations, contingent liabilities, commitments, early retirement pensions along with benefits prior to retirement age replacing the former, severance pay and environmental protection liabilities specified by law.

Provisions may be recognised for certain significant, expected and periodically recurring future costs. Thus, the Act on Accounting lists maintenance, restructuring and environmental protection costs in particular.

This raises a number of questions: can obligations be derived from contracts or legal regulations only, or should so-called constructive obligations be included, too? Obligations are constructive if they arise from past general practices, public policies or a sufficiently specific declaration in the current reporting period. Based on all this, other parties rightly expect the entity to take responsibility and fulfil its obligations accordingly. This may be a case when the entity has no legal obligation for environmental protection, but in line with its publicly-known practice it regularly eliminates environmental

damage. Should the entity recognise provisions in this case? The Act on Accounting prescribes a compulsory provisioning obligation for environmental protection liabilities, while this is only an option for costs related to environmental protection. But what is the difference between the two?

According to the Act on Accounting, provisions may be recognised for restructuring costs. This may raise the question as to whether provisions should or may be allocated for payments for expected terminations of contract or employment if restructuring was already decided, and even announced, resulting in the termination of certain contracts and the dismissal of employees. Likewise, if the solvent liquidation of an entity has been decided and announced, but no decision has yet been made on the fate of the employees, should provisions be recognised for termination benefits?

The date when the obligation arises may also be questionable. For example, does the termination benefits obligation arise when the decision is made, or when the decision is communicated to the employees? If the decision was made prior to the reporting date, but only announced after the reporting date though before balance sheet preparation, should its effect be reflected in the balance sheet on the reporting date?

In the case of asset-related obligation, does it matter whether the obligation arises upon creating the asset or during its use? For instance, if upon the establishment of a production plant there is a legal or contractual obligation to decommission and restore the initial state of a plant when the plant is closed, we could even conclude, depending on the facts and circumstances, that the obligation arises when the asset is established. According to the International Financial Reporting Standards (IFRS), provisions recognised for the entire obligation arising from plant establishment shall be capitalised in the cost of the asset. But how does this comply with the provisions of the Act on Accounting? Should the provision be recognised for the entire expected payment obligation when the plant is established, or should the provision be built up during operation? The Act on Accounting prescribes that provisions must be charged to profit before tax, and does not provide an option for similar items to be capitalised in the cost of an asset.

Pursuant to the Act on Accounting, provisions must be recognised for obligations that probably or certainly exist, but whose amount or due date is still uncertain. In the case of lawsuits, for example, there can be uncertainty as to whether there are legal grounds for the other party's claim. The level of uncertainty depends on the entity's judgement. But what level of certainty justifies the recognition of the obligation in the balance sheet? When should the obligation be recognised in the case of tax authority findings, for example? Is it sufficient to have the minutes on the findings, or should the date of the resolution be decisive? Should we perhaps wait until the case goes to court and a legally binding decision is made? It seems reasonable to assume that the more legal remedy opportunities are used up by the entity, the more likely it is that the other party's claim is legitimate and the obligation exists.

Can the impacts of future events be considered when determining the amount of provisions? For example the impact of technological advancement or future decisions to be made by management? Some think that the impact of future decisions made by management to avoid fulfilling the obligation cannot be taken into account, e.g. that the conditions will be amended during negotiations with the other party.

How should expected recovery be taken into account? Can expected recovery be looked upon as another way of providing the necessary coverage? When settling an obligation, for example, the entity expects compensation from the insurance company, or another party (e.g. parent company) reimburses or is likely to reimburse the paid sum, can the provision amount be reduced accordingly? Some believe so, but is it sufficient for the entity to expect that its costs will be reimbursed, or should it perhaps have a contract or a binding confirmation from the other party?

A further question is how to take into account when a future transaction is likely to cover the settlement of the obligation. Sticking with the previous example, if an obligation arising from the closure of the plant is to be settled in part or in full

by selling the decommissioned assets, can the amount of provisions be reduced by the sum of the expected gain? It is especially worthwhile thinking about this if there is no possibility to sell the related assets before the closure of the plant and the commencement of environmental remediation, and they are not measured at their market value.

Which items can be taken into account when determining the amount of provisions? Can provisions be recognised for other costs related to the settlement of the obligation, e.g. expected legal costs in the case of lawsuits? Do costs include all direct expenses or only those that would have not been incurred had there been no lawsuit?

The Act on Accounting does not provide guidance on how to measure the amount of provisions. Can the amount of provisions be determined as the probability weighted average of the potential outcomes and their amounts, or as the amount of the most likely outcome? In the case of lawsuits, the entity either loses the case and has to pay, or wins. Even if they win, the payable amount might be still questionable. If the company opts for probability weighted average, it can happen that they recognise an amount that does not equal any of the payable amounts expected in the case of the potential outcomes.

Estimates are needed in many cases when quantifying provisions, during which choosing the appropriate estimation method may cause difficulties. For instance, it may be difficult to determine warranty provisions for a newly established entity or a new product if previous statistical data is unavailable.

For certain obligations, payments must only be made far into the future. This raises the following question: should the time value of money be considered when determining the amount of provisions, i.e. should expected future payments be discounted? The Act on Accounting includes no requirements regarding this, therefore some believe that both methods are acceptable.

A series of questions remains unanswered. Obligations denominated in foreign currency should also be mentioned. How should the effect of exchange rate changes be dealt with? The Act on Accounting only prescribes the reporting-date revaluation for foreign currency liabilities. The Act on Accounting as amended in November 2014 extends this provision only to accrued expenses. This could lead to the logical conclusion that the amount of provisions recognised for obligations denominated in foreign currency should be determined at the exchange rate on the reporting date, but can the effects of the fluctuating exchange rate be recognised in the financial result, or should this be accounted for as recognition or release of provisions?

In practice, situations can arise when a contract becomes onerous due to changing conditions. IFRS deem a contract to be onerous if the unavoidable costs of discharging the contractual obligations are higher than the economic benefits expected based on the contract. This may be the case when the contract must be fulfilled at a fixed price, and it is

expected to lead to future losses due to increases in purchase prices and costs. The entity may decide to maintain the loss-making contract, or accept the legal consequences of terminating the contract. Different financial consequences may result for the two options. Based on IFRS, provisions must be recognised for onerous contracts. However, the Act on Accounting does not recognise the concept of onerous contracts. Despite this, should provisions be recognised for such contracts? If yes, should the amount of the provision be determined assuming the contract is continued or terminated? The entity does not necessarily choose the less unfavourable option since other business aspects (e.g. customer relationship, good reputation) also influence the decision. Some believe that if the entity's decision has an impact on the amount of the payment obligation, then the provision should be measured assuming the decision which will result in the lowest payment obligation.

Some final words

Several issues were examined above as to whether entities have any obligations as at the reporting date for which provisions need to be made, and how to measure the amounts of provisions.

In this newsletter we did not intend to cover all types of transaction or address all the issues that may arise in this context. If you still have any uncertainties or our newsletter provided you with food for thought, we recommend you contact your tax or accounting advisor, or us, because meticulously planned and thorough methodology can make a significant contribution to ensuring annual reports provide a true and fair view of companies' net assets and financial positions as well as the results of their operations.

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