Provisions, Contingent Liabilities and Contingent Assets (IAS 36)

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Provisions, Contingent Liabilities and Contingent Assets (IAS 36)

Case

煤氣 Towngas

- The Group is principally engaged in the production, distribution and marketing of gas, water and related activities in Hong Kong and Mainland China.
- Its annual report of 2006 explained in its accounting policy for provisions and contingencies.

Provision in HK Housing Society

Case

- **Provision for property development cost**
  - was made for the remaining development work to be carried out
  - for the completed sales properties,
  - which was expected to be incurred within the next 2 financial years.

- **Provision for home loan warranty**
  - was made for the sale of loans receivable with a warranty clause that required the Housing Society to bear part of the loss incurred by the buyer in the event that
    - the borrowers were in default and
    - administration charge waived by the buyer for early redemption of loans.
  - The warranty will expire 7 years from the dates of sales.

Objective of IAS 37

- To ensure appropriate recognition criteria and measurement bases are applied to

Provision

Contingent liabilities

Contingent assets

  - that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount

Scope of IAS 37

- IAS 37 shall be applied by all entities in accounting for

Provision

Contingent liabilities

Contingent assets

- Except:
  a) those resulting from executory contracts, except where the contract is onerous; and
  b) those covered by another IFRS

→ **Executory contracts** are not covered by IAS 37, but **Onerous executory contracts** are covered by IAS 37 (discussed later)

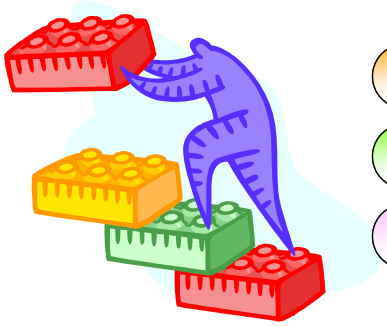
- Executory contracts are contracts under which
  - neither party has performed any of its obligations or
  - both parties have partially performed their obligations to an equal extent

Today's Agenda

Provision

Contingent liabilities

Contingent assets



Measurement

Application

Disclosure

IAS 37

Case

- Annual report of 2006 explained in its accounting policy for provisions:
  - Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.
  - Where the Group expects a provision to be reimbursed, the reimbursement is recognised as a separate asset when the reimbursement is virtually certain.
  - Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to passage of time is recognised as interest expense.

Provisions

Definition

Provision

- A provision is
  - a liability of uncertain timing or amount
- A liability is
  - a present obligation of the entity arising from past events,
  - the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits
- Not include those adjustments to the carrying amount of assets, say provision for depreciation, provision for doubtful debt
- Distinguished from other liabilities such as trade payables and accruals because there is
  - Uncertainty about the timing or
  - Uncertainty about the amount of the future expenditure required in settlement

Provisions

Definition → Recognition

Present obligation
⇓
Past event
⇓
Probable outflow
⇓
Reliable estimate

- A provision shall be 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 these conditions are not met, no provision shall be recognised.

Provisions

Definition → Recognition

Present obligation

- In almost all cases it will be clear whether a past event has given rise to a present obligation.
- In rare cases it is not clear whether there is a present obligation
  - e.g. a lawsuit
- In these 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
  - The evidence includes the opinion of experts, say lawyers

Provisions

Definition → Recognition

Present obligation

- On the basis of such evidence:
  a) where it is more likely than not that a present obligation exists at the balance sheet date
     ⇒ the entity recognises a provision (if other recognition criteria are also met); and
  b) where it is more likely that NO present obligation exists at the balance sheet date
     ⇒ the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote

Provisions

Example

Present obligation

- Entity A
  - gives warranties at the time of sale to buyers of its product
  - commits to make good (by repair or replacement) manufacturing defects that become apparent within 3 years from the date of sale
- On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.
- Is there present obligation as a result of a past obligating event?

Yes

- The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.
- As it is also probable to have an outflow of resources embodying economic benefits in settlement, a provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date.

Provisions

Definition → Recognition

Present obligation
⇓
Past event

- A past event that leads to a present obligation is called an

Obligating event

Legal Obligation

Constructive Obligation

An obligating event is an event that creates

– a legal obligation or constructive obligation

– that results in an entity having no realistic alternative to settling that obligation

Provisions

Definition → Recognition

Present obligation
⇓
Past event

Legal obligation is an obligation that derives from:

a) a contract (through its explicit or implicit terms);
b) legislation; or
c) other operation of law.

Legal Obligation

Constructive Obligation

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

Provisions

Definition → Recognition

Present obligation
⇓
Past event

- The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date.
  - Independent of future actions (i.e. the future conduct of business)
  - Examples of such obligations are
    - Penalties or clean-up costs for unlawful environmental damage
    - Provision for the decommissioning costs of an oil installation (to the extent that the entity is obliged to rectify damage already caused)

Provisions

Example

Present obligation
⇓
Past event

- Entity A in the nuclear power industry causes contamination but cleans up only when required by the law.
- Country X in which Entity A operates has had no legislation requiring cleaning up, and Entity A has been contaminating land there for many years.
- At 31 Dec. 2000, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year end.
- Is there present obligation as a result of a past obligating event?

Yes

- The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.
- As it is also probable to have an outflow of resources embodying economic benefits in settlement, a provision is recognised for the best estimate of the costs of the clean-up

Provisions

Example

Present obligation
⇓
Past event

- Entity C operating power station
  - causes contamination and in Country Z where there is no environmental legislation.
  - has a widely published environmental policy in which it undertakes to clean up all contamination that it causes.
  - has a record of honouring this published policy.
- Is there present obligation as a result of a past obligating event?

Yes

- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.
- As it is also probable to have an outflow of resources embodying economic benefits in settlement, a provision is recognised for the best estimate of the costs of the clean-up

Provisions

Definition → Recognition

Present obligation
⇓
Past event
⇓
Probable outflow

- For recognition of provision, an entity also considers
  - the probability of an outflow of resources embodying economic benefits to settle that obligation
- An outflow of resources (or other event) is regarded as probable if the event is more likely than not to occur
  - i.e. the probability that the event will occur is greater than the probability that it will not
- Where it is not probable that a present obligation exists
  - ➢ an entity discloses a contingent liability, unless the possibility is remote
- Where there are a number of similar obligations (e.g. product warranties or similar contracts)
  - ➢ the probability is determined by considering the class of obligations as a whole

Provisions

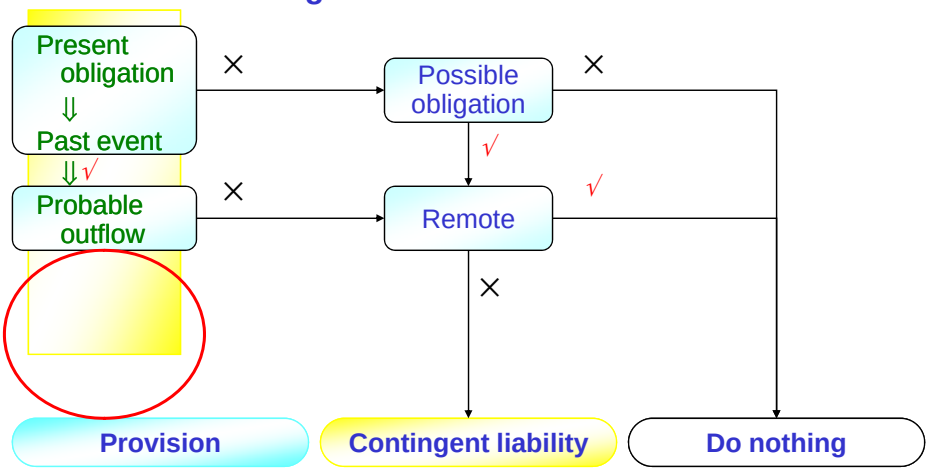
Case

Hong Kong Aircraft Engineering Company Limited Annual Report 2005 states:

- Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow
- of resources will be required to settle the obligation; and the amount has been reliably estimated.
- Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole.
- A provision is recognised even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

Provisions

Definition → Recognition



Provisions

Definition → Recognition

Present obligation
⇓
Past event
⇓
Probable outflow
⇓
Reliable estimate

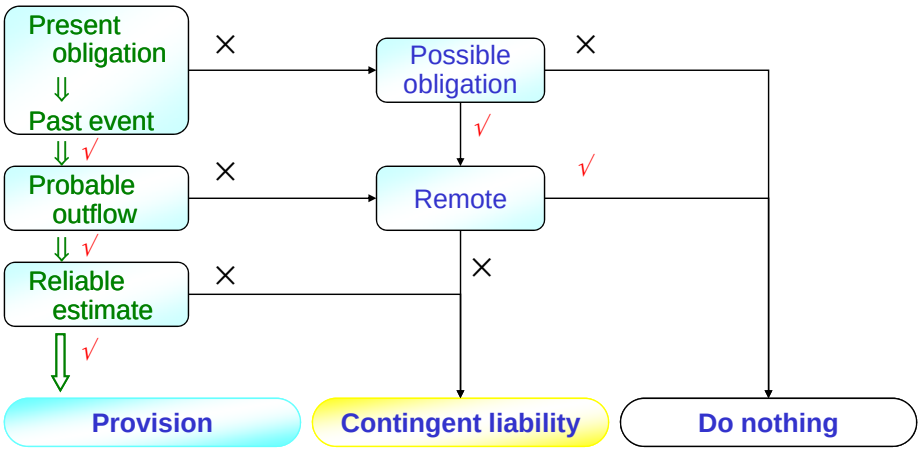
- Use of estimates
  - an essential part of the preparation of financial statements
  - does not undermine their reliability
  - especially true in the case of provisions, which by their nature are more uncertain than most other balance sheet items.
- An entity (except in extremely rare cases)
  - will be able to determine a range of possible outcomes and
  - can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

Provision

More on measurement ……

Provisions

Definition → Recognition



Provisions

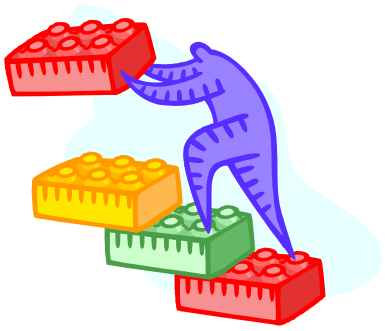
Case

Medecins Sans Frontieres (International Financial Report 2004):

- Provisions and contingent liabilities are valued at their best estimate when MSF has a legal or constructive obligation as the result of a past event, and if it is probable that an outflow of assets will be required to settle the provision.

Today's Agenda

Contingent liabilities



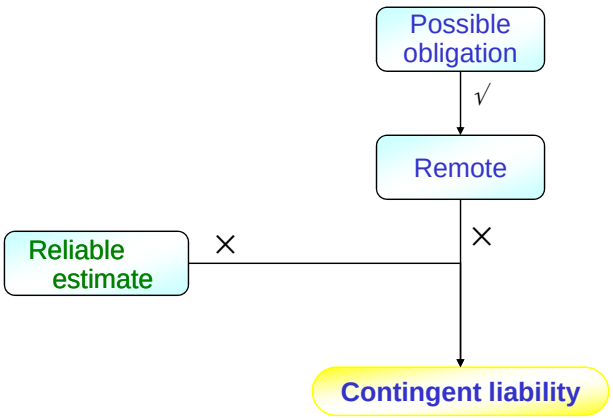
Contingent Liabilities

Definition → No Recognition → Disclosed unless remote

- A contingent liability is:
  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 recognised 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.
- An entity shall not recognise → **Contingent liability**

Contingent Liabilities

Definition → No Recognition → Disclosed unless remote



Contingent Liabilities

Case

- Annual report of 2006 explained in its accounting policy for contingencies as follows:
  - A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group.
  - It can also be a present obligation arising from past events that is not recognised because it is not probable that an outflow of economic resources will be required or the amount of obligation cannot be measured reliably.
  - A contingent liability is not recognised but is disclosed in the notes to the accounts.
  - When a change in the probability of an outflow occurs so that the outflow is probable, it will then be recognised as a provision.

Contingent Liabilities

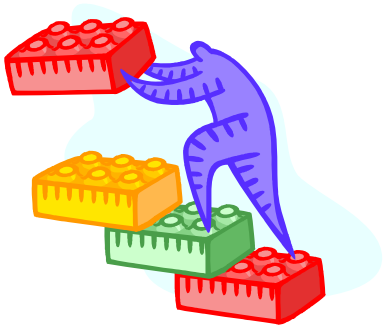
Case

Cheung Kong (Holdings) Limited

Annual report 2006:

- The Group's share of contingent liability of jointly controlled entity in respect of guaranteed return payments payable to the other party of a co-operative joint venture in the next 43 years amounted to HK$4,488 million;
- The minimum share of revenue/profit guaranteed by the Company to be received by other partners of joint development projects amounted to HK$1,422 million (2005 – HK$672 million)
- The Company provided guarantees for loan financing as follows:
  - bank and other loans utilised by subsidiaries – HK$34,182 million (2005 – HK$22,205 million)
  - loan from joint development partner to a subsidiary – HK$4,000 million (2005 – Nil)
  - bank loans utilised by jointly controlled entities – HK$1,130 million (2005 – HK$1,109 million) and certain subsidiaries provided guarantees for bank loans utilised by jointly controlled entities amounted to HK$2,571 million (2005 – HK$3,622 million)

Today's Agenda



Contingent assets

Contingent Assets

Definition → No Recognition → Disclosed

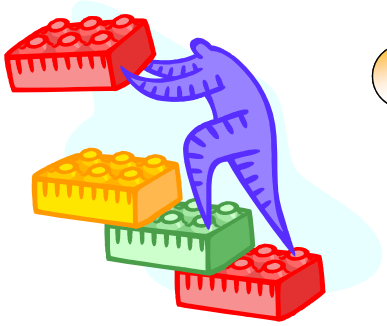
- A contingent asset is:
  - a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
- An entity shall not recognise a contingent asset

Contingent Assets

Case

- Annual report of 2006 explained in its accounting policy for contingencies as follows:
  - A contingent asset is 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 events not wholly within the control of the Group.
  - Contingent assets are not recognised but are disclosed in the notes to the accounts when an inflow of economic benefits is probable.
  - When inflow is virtually certain, an asset is recognised.

Today's Agenda



Measurement

Provisions – Measurement

Definition → Recognition → Measurement

1. Best estimate
   - the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.
   - expected value can be used

2. Risks and uncertainties
   - that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision

Provision

Provisions – Measurement

Definition → Recognition → Measurement

3. Present Value
   - where the effect of the time value of money is material
     - the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation
   - the discount rate shall be a pre-tax rate that reflects
     - current market assessments of the time value of money and
     - the risks specific to the liability
     - not reflect risks for which future cash flow estimates have been adjusted

Provision

Provisions – Measurement

Definition → Recognition → Measurement

4. 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

5. Expected disposal of assets
   - shall not be taken into account

Provision

Provisions – Measurement

Example

- Entity A is involved in a court case about the plagiarism of software.
- Legal opinion seems to indicate that Entity A will lose the case.
- Entity A estimates that
  - the most likely outcome (60% chance) will be a settlement payment of costs and penalties of $1 million in 2 years' time
  - the best case scenario (30% chance) is deemed to be a settlement payment of $500,000 in one year's time and
  - the worst case scenario (10% chance) will be a settlement payment of $2 million in 3 years' time (discount rate is 5%)

Provisions – Measurement

Example

- As regards the plagiarism case the following table illustrates the potential outcomes (present values at 5%):

	$000	*Year*	*PV($000)*	*Probability*	*Total ($)*
Best case	500	1	476	30%	142,857
Most likely	1,000	2	907	60%	544,218
Worse case	2,000	3	1,728	10%	172,768
					859,843

- As compared with the most likely outcome, which indicates a provision of $907,000, the expected value of the provision as above is $859,843.
- The difference, while an accounting estimate has been used, is not material.
- In consequence, a provision of $860,000 can be made as it is estimated by a more scientific approach.

Provisions – Measurement

Case

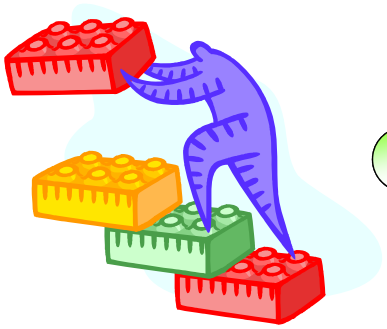
HONG KONG TOURISM BOARD

Annual Report 2004/05:

- Provisions are recognised for liabilities of uncertain timing or amount when the Board has a legal or constructive obligation arising as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made.

- Where the time value of money is material,
  - provisions are stated at the present value of the expenditure expected to settle the obligation.

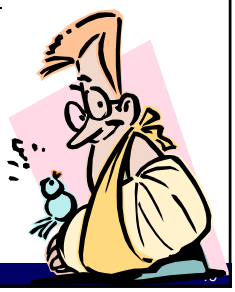
Today's Agenda



Application

Provisions – Reimbursements

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party
  - the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.
  - The reimbursement shall be treated as a separate asset.
  - The amount recognised for the reimbursement shall not exceed the amount of the provision.
  - In the income statement, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.



Provisions – Reimbursements

Case

- 2005 Annual Report stated its accounting policy on provisions as follows:
  - Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.
  - Where the Group expects a provision to be reimbursed,
    - the reimbursement is recognised as a separate asset
    - but only when the reimbursement is virtually certain.

殷威汽車有限公司
DENWAY MOTORS LIMITED

Provisions – Reimbursements

Case

醫院管理局
HOSPITAL AUTHORITY

Annual Report 2004/05:

- Provisions are recognised when the HA has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.

- Where the HA expects a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

Provisions – Changes and Use

- Provisions shall 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 embodying economic benefits will be required to settle the obligation
  - ➢ the provision shall be reversed.
- A provision shall be used only for expenditures for which the provision was originally recognised.

Provisions – Application

- **Future operating losses**
  - Provisions shall not be recognised for future operating losses
- **Onerous Contracts**
  - Being a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it

    (unavoidable cost > economic benefits expected)
  - If an entity has a contract that is onerous, the present obligation under the contract
    - ➢ shall be recognised and measured as a provision

Provisions – Application

Example

- Entity A operates profitably from a factory that it has leased under an operating lease.
- During the year, Entity A relocates its operations to a new factory.
- The lease on the old factory continues for the next 4 years.
- Entity A cannot cancel that lease and the factory cannot be re-let to another user.

- The obligating event is the signing of the lease contract, which gives rise to a legal obligation.
- When the lease becomes onerous *(unavoidable costs > economic benefits)*, an outflow of resources embodying economic benefits is probable.
- Until the lease becomes onerous, it is accounted under IAS 17 *Leases*.
- A provision is recognised for the best estimate of the unavoidable lease payments.

Provisions – Application

Restructuring

- A restructuring is a programme that is planned and controlled by management, and materially changes either:
  a) the scope of a business undertaken by an entity; or
  b) the manner in which that business is conducted
- A constructive obligation to restructure arises only when an entity:
  a) has a detailed formal plan for the restructuring identifying at least:
     i) the business or part of a business concerned;
     ii) the principal locations affected;
     iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
     iv) the expenditures that will be undertaken; and
     v) when the plan will be implemented; and
  b) has raised a valid expectation in those affected that it will carry out the restructuring by
     i) starting to implement that plan or
     ii) announcing its main features to those affected by it.

When shall provision be recognised?

Provisions – Application

Restructuring

- No obligation arises for the sale of an operation until the entity is committed to the sale, i.e. there is a binding sale agreement.
- A restructuring provision shall <u>include only the direct expenditures</u> arising from the restructuring, which are those that are both:
  a) necessarily entailed by the restructuring; and
  b) not associated with the ongoing activities of the entity.
- A restructuring provision <u>does not include</u> such costs as:
  a) retraining or relocating continuing staff;
  b) marketing; or
  c) investment in new systems and distribution networks.

Provisions – Application

- The line of business of Pohler Speed, a public limited company, is global mail, logistics and financial services. The financial director wishes to prepare a report on the key points in the financial statements for the year ended 30 November 2004 in which the company has reported a net profit before tax of $500 million.
- A formal announcement for a further restructuring of the group was made after the year-end on 5 December 2004. A provision has not been made in the financial statements as a public issue of shares is being planned and the company does not wish to lower the reported profits. Prior to the year-end, the company has sold certain plant and issued redundancy notices to some employees in anticipation of the formal commencement of the restructuring. The company prepared a formal plan for the restructuring which was approved by the board and communicated to the trade union representatives prior to the year-end.
- The directors estimate the cost of the restructuring to be $60 million, and it could take up to 2 years to complete the restructuring. The estimated cost of restructuring includes $10 million for retraining and relocating existing employees, and the directors feel that costs of $20 million (of which $5 million is relocation expenses) will have been incurred by the time the financial statements are approved.

Provisions – Application

Answers

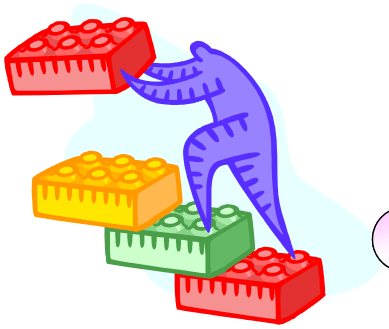
- IAS 37 sets out the general recognition criteria for a provision. However, in the case of restructuring provisions, an obligating event must have arisen. It is unlikely that a liability will arise from a legal obligation as the obligation is likely to be constructive by nature. Specific conditions have to exist before a constructive obligation can exist. These conditions are:
  - i) a detailed formal plan for the restructuring must exist
  - ii) a valid expectation must have been raised in those affected by the reorganisation
- In the case of Pohler Speed, the company has approved the restructuring and communicated it via the trade unions to employees prior to the year-end and effectively commenced the restructuring by issuing redundancy notices and selling plant.
- The public announcement of the plan after the year-end does not of itself trigger the restructuring nor create the 'valid expectation'.
- Similarly, neither does the board decision alone create a constructive obligation.

Provisions – Application

Answers

- However, prior to the year-end the company has started to implement the plan and has announced the main features of the plan to those affected by it, and, therefore, it would seem that a 'valid expectation' has been created and a provision should be made.
- The only issue is that the restructuring is expected to take two years to complete that may mean that the provision is premature as the company could change the plan.
- However, it would appear from the above that a provision of $15 ($20m – $5m) million should be made, as the cost of retraining and relocating staff is not allowed as valid expenditure to be included in a restructuring provision because the costs relate to the future conduct of the business.
- Where a restructuring will take a long time, then it is unlikely that all of the reorganisation will represent an obligation at the first year-end. Costs are likely to be charged over a number of accounting periods.
- Thus the totality of the costs should be disclosed and maybe the costs which are known to be incurred by the time of the approval of the financial statements should be provided for.
- This is an area where there can be considerable debate.

Today's Agenda



Disclosure

Disclosure – Provisions

- For each class of provision, an entity shall disclose:
  a) the carrying amount at the beginning and end of the period;
  b) additional provisions made in the period, including increases to existing provisions;
  c) amounts used (i.e. incurred and charged against the provision) during the period;
  d) unused amounts reversed during the period; and
  e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.
- Comparative information is not required.
- An entity shall disclose the following for each class of provision:
  a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
  b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
  c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Disclosure – Contingent Liabilities

- Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
  a) an estimate of its financial effect;
  b) an indication of the uncertainties relating to the amount or timing of any outflow; and
  c) the possibility of any reimbursement.

Disclosure – Other

- Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the balance sheet date, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-52 of IAS 37
- Where any of the information required in IAS 37 is not disclosed because it is not practicable to do so, that fact shall be stated.
- In extremely rare cases, disclosure of some or all of the information can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset.
- In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Other Examples

Example

- On 31 Dec. 2007, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound.
- During 2008, the financial condition of Entity B deteriorates.
- At 30 June 2008 Entity B files for protection from its creditors.

- This contract meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*.
- IFRS 4 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied.
- It also permits changes in accounting policies that meet specified criteria.

Other Examples

Example

- Example of an accounting policy that IFRS 4 permits:
  - The obligating event is the giving of the guarantee, which gives rise to a legal obligation
  - at 31 December 2007, no outflow of benefits is probable
    - ➢ The guarantee is recognised at fair value
  - at 31 December 2008, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
    - ➢ The guarantee is subsequently measured at the higher of
      - a) the best estimate of the obligation, and
      - b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with IAS 18 Revenue.

Provisions – Case

Case

- Pursuant to the Cyberport Project Agreement, the Government shall be entitled to receive payments of surplus cashflow arising from the sales of the residential portion of the Cyberport project, net of certain allowable costs ……
- Provision for payment to the Government is included within properties under development as the amount is considered as part of the development costs of the Cyberport project.
- The provision is based on
  - estimated sales proceeds of the residential portion, and
  - estimated development costs of the Cyberport project.

IFRIC Interpretations 1

1. Background – Requirements under Current Framework
2. Scope
3. Issue
4. Consensus
5. Effective Date and Transition

1. Background

- In installing or constructing items of property, plant and equipment, entities have obligations to dismantle, remove and restore such items.

Such obligations are referred to as Decommissioning, Restoration and Similar Liabilities in IFRIC-Int 1

- For example, a decommissioning, restoration or similar liability may exist for
  - decommissioning a plant,
  - rehabilitating environmental damage in extractive industries, or
  - removing equipment.

1. Background

Case

BP plc, the largest integrated oil company adopted IFRS in 2005, stated its accounting policies that:

- Property, plant and equipment
  - The initial cost of an asset (property, plant and equipment) comprises
    - its purchase price or construction cost,
    - any costs directly attributable to bringing the asset into operation and
    - the initial estimate of any decommissioning obligation.
- Decommissioning
  - Liabilities for decommissioning costs are recognized
    - when the Group has an obligation to dismantle and remove a facility or an item of plant and to restore the site on which it is located, and
    - when a reasonable estimate of that liability can be made.
  - Where an obligation exists for a new facility ……. this will be on construction or installation.

1. Background

For decommissioning, restoration or similar liabilities

- IAS 16 *Property, Plant and Equipment*
  - sets out the requirements in recognising such costs as part of the cost of an item of property, plant and equipment.
- IAS 37 *Provision, Contingent Liabilities and Contingent Assets*
  - sets out the requirements on how to measure decommissioning, restoration and similar liabilities.
- IFRIC Interpretation 1
  - provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.

Initial Recognition

Measurement

Changes in Measurement

1. Background: Current Framework

In IAS 16, the cost of PPE comprises:

1. Purchase price
2. Directly attributable costs (DAC)
3. Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either
   - when the item is acquired, or
   - as a consequence of having used the item during a particular period for purposes, other than to produce inventories during that period *(also refer IAS 37)*

(New in IAS 16)

Initial Recognition

e.g. air-condition plant are installed in leasehold head office or a showroom

- In addition to the normal removal cost, the original restoring cost is also estimated for damage or pollution incurred during the lease term

1. Background: Current Framework

- IAS 37 specifies how to measure provision, including decommissioning, restoration or similar liabilities.
- The requirements include:
  - The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.
  - Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.
  - The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.
    - The discount rate shall not reflect risks for which future cash flow estimates have been adjusted.

Initial Recognition

Measurement

All these can be changed

1. Background: Current Framework

Example

- Entity A operates an offshore oilfield where its 20-year licensing agreement requires it to remove the oil rig at the end of production and restore the seabed.
- In Year 0, it estimates that the costs of removal of the oil rig and restoration of the seabed include:
  - 75% relates to damage caused by building the oil rig
  - 10% relates to damage caused by regular maintenance of the oil rig
  - 15% arises through the extraction of oil

85%

- The cost of the oil rig
  - includes the best estimate of **85%** of the eventual costs
  - a provision in the amount of that cost will be recognised when the oil rig has been constructed.

removal of the oil rig and restoration of damage caused by building it

for purposes, other than to produce inventories during that period

recognised as a liability when the oil is extracted

1. Background: Current Framework

Case

BP plc, after adopting IFRS, stated its accounting policies that:

- Decommissioning
  - Liabilities for decommissioning costs are recognized ……
    - The amount recognized is the present value of the estimated future expenditure determined in accordance with local conditions and requirements.
  - A corresponding tangible item of property plant and equipment of an amount equivalent to the provision is also created.
  - This is subsequently depreciated as part of the capital costs of the facility or item of plant.

Initial recognition

Dr PPE
Cr Liabilities

Subsequent measurement

Dr Depreciation
Cr Accumulated dep.
Being annual depreciation

Dr Finance cost
Cr Liabilities
Being discount unwinding

2. Scope

IFIC Interpretation 1 applies to changes in the measurement of any existing decommissioning, restoration or similar liability that is both:

a) recognised as part of the cost of an item of property, plant and equipment accordance with IAS 16; and

b) recognised as a liability in accordance with IAS 37.

Changes in Measurement

3. Issue

Changes in measurement may be resulted from:

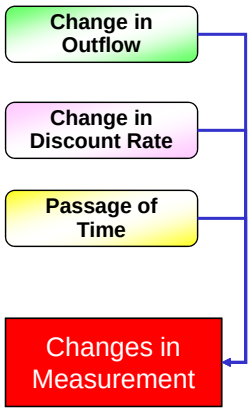
a) a change in the estimated outflow of resources embodying economic benefits (e.g. cash flows) required to settle the obligation;

b) a change in the current market-based discount rate as defined in IAS 37 (incl. changes in the time value of money and the risks specific to the liability); and

c) an increase that reflects the passage of time (also referred to as the unwinding of the discount).

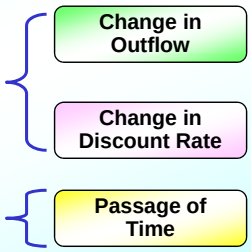
IFRIC Interpretation 1 addresses

– how the effect of the above events that change the measurement of an existing decommissioning, restoration or similar liability should be accounted for.



4. Consensus

- The accounting treatments for such changes in the measurement depend on the nature of changes
  - a) For the changes resulted from
    - i) changes in outflow of resources to settle the obligation and
    - ii) changes in discount rate
  - b) For the changes resulted from unwinding of the discount



4. Consensus

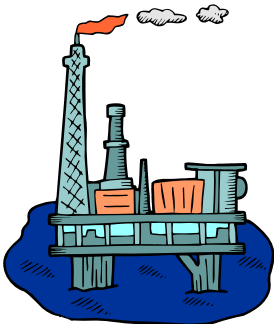
Changes resulted from

Change in Outflow | Change in Discount Rate

Cost Model | Revaluation Model

- The related assets relating the decommissioning, restoration or similar liability may have been measured by using
  1) Cost model
  2) Revaluation model

  under IAS 16
- The model chosen would have effect on the accounting treatment.



4. Consensus

Changes resulted from

Change in Outflow | Change in Discount Rate

Cost Model

Add to or reduce asset cost

If the related asset is measured using Cost Model:

- subject to some limitations, changes in the liability shall be
  - added to, or
  - deducted from,

  the cost of the related asset in the current period.

- if it is an addition to the asset cost, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable.
- If it is such an indication, the entity shall test the asset for impairment and account for any impairment loss, in accordance with IAS 36.

- the amount deducted from the cost of the asset shall not exceed its carrying amount.
- If a decrease in the liability exceeds the carrying amount of the asset, the excess shall be recognised immediately in profit or loss.

4. Consensus

Example

Entity OB has a nuclear power plant and a related decommissioning liability.

- The plant started operating on 1 Jan. 2000 with a useful life of 40 years.
- Its initial cost was $120,000, included decommissioning costs of $10,000
  - representing $70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5%.

On 31 Dec. 2009, the plant is 10 years old with a carrying amount of $90,000 and accumulated depreciation of $30,000 ($120,000 x 10/40 years).

- Because of the unwinding of discount (5%) over the 10 years, the decommissioning liability has grown from $10,000 to $16,300.
- Even the discount rate has not changed, OB estimates that, as a result of technological advances, the present value of the decommissioning liability has decreased by $8,000 (i.e. from $16,300 to $8,300).

What is the effect of the change?

On 31 Dec. 2009, OB shall make the following journal entry to reflect the change:

Dr	Decommissioning liabilities	$8,000	
Cr	PPE - Cost of asset		$8,000

The carrying amount of the plant will decrease to $82,000 ($90,000 - $8,000)

4. Consensus

Case

Changes resulted from

Change in Outflow | **Change in Discount Rate**

Cost Model

Add to or reduce asset cost

BP plc, after adopting IFRS in 2005, stated its accounting policies that:

- Property, plant and equipment
  - is stated at cost less accumulated depreciation and accumulated impairment losses.

Cost model

- Decommissioning
  - Liabilities for decommissioning costs are recognized ……
  - Any change in the present value of the estimated expenditure is reflected as an adjustment to
    - the provision and
    - the corresponding property, plant and equipment.

Change in measurement

bp

4. Consensus

Changes resulted from

Change in Outflow | Change in Discount Rate

Revaluation Model

If the related asset is measured using the Revaluation Model:

- changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:
  - i) a decrease in the liability shall (subject to the limitation as discussed later) be credited directly to revaluation surplus in equity,
    - – except that it shall be recognised in profit or loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in profit or loss;
  - ii) an increase in the liability shall be recognised in profit or loss,
    - – except that it shall be debited directly to revaluation surplus in equity to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Direct credit to revaluation surplus (other than deficit reversal)

Recognise in profit or loss (other than revaluation surplus exists)

4. Consensus

Example

If there is a decrease in the decommissioning liability of $100

Dr	Decommissioning liabilities	$100	
Cr	Revaluation surplus		$100

In case a revaluation deficit over $100 recognised in profit and loss before:

Dr	Decommissioning liabilities	$100	
Cr	Profit and loss		$100

Direct credit to revaluation surplus (other than deficit reversal)

If there is an increase in the decommissioning liability of $200

Dr	Profit and loss	$200	
Cr	Decommissioning liabilities		$200

Recognise in profit or loss (other than revaluation surplus exists)

In case there is a revaluation surplus over $200:

Dr	Revaluation surplus	$200	
Cr	Decommissioning liabilities		$200

4. Consensus

Changes resulted from

Change in Outflow | Change in Discount Rate

Revaluation Model

If the related asset is measured using the Revaluation Model:

- In the event that
  - a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model (*i.e. the carrying amount if revaluation model is not adopted)*
    - the excess shall be recognised immediately in profit or loss.

4. Consensus

Example

- Entity OB has a nuclear power plant of Entity OB operating for a year with a carrying amount of $100,000 (including decommissioning cost).
- At year end, OB revalued the plant at $120,000 plus decommissioning costs of $12,000. (Totally $132,000)
- 2 months later, because of new technology, the directors of OB estimates that the present value of the decommissioning liability has decreased by $5,000.
- Accordingly, the decommissioning liability would reduce from $12,000 to $7,000.
- What is the impact on OB's financial statements?

OB shall make the following journal entry to reflect the change:

Dr	Decommissioning liabilities	$5,000	
Cr	Revaluation surplus		$5,000

The whole of this adjustment is taken to revaluation surplus, because it does not exceed the carrying amount that would have been recognised had the asset been carried under the cost model (i.e. $100,000).

The carrying amount of the asset would be $127,000 ($132,000 - $5,000).

4. Consensus

Changes resulted from

Change in Outflow | Change in Discount Rate

Revaluation Model

- A change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.
  - Any such revaluation shall be taken into account in determining the amounts to be taken to profit or loss and equity under this Interpretation.
  - If a revaluation is necessary, all assets of that class shall be revalued.

Trigger revaluation

- IAS 1 requires disclosure on the face of the statement of changes in equity of each item of income or expense that is recognised directly in equity.
  - In complying with this requirement, the change in the revaluation surplus arising from a change in the liability shall be separately identified and disclosed as such.

4. Consensus

Changes resulted from

Change in Outflow | Change in Discount Rate

Revaluation Model

When accounting for revalued assets to which decommissioning liabilities attach, it is important to understand the basis of the valuation obtained.

- For example if the asset is valued on a discounted cash flow basis:
  - some valuers may value the asset without deducting any allowance for decommissioning costs (a 'gross' valuation)
  - other valuers may value the asset after deducting an allowance for decommissioning costs (a 'net' valuation)
    - as assuming an entity acquiring the asset will generally also assume the decommissioning obligation.
  - For financial reporting purposes, the decommissioning obligation is recognised as a separate liability, and is not deducted from the asset (i.e. should be on a gross basis).
  - Thus, if the asset is valued on a **net basis**,
    - it is necessary to adjust the valuation obtained by adding back the allowance for the liability, so that the liability is not counted twice.

Trigger revaluation

Value adjustment required

4. Consensus

Changes resulted from

Change in Outflow | Change in Discount Rate

Revaluation Model

When accounting for revalued assets to which decommissioning liabilities attach, it is important to understand the basis of the valuation obtained.

- For example if an asset is valued on a depreciated replacement cost basis:
  - the valuation obtained may not include an amount for the decommissioning component of the asset.
  - If it does not include such decommissioning component,
    - an appropriate amount will need to be added to the valuation to reflect the depreciated replacement cost of that component.

Trigger revaluation

Value adjustment required

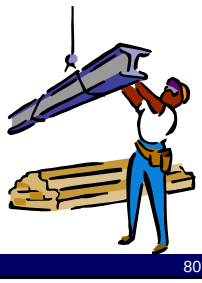
4. Consensus

Changes resulted from

Change in Outflow | Change in Discount Rate

Cost Model | Revaluation Model

- The adjusted depreciable amount of the asset is depreciated over its useful life.
- Therefore, once the related asset has reached the end of its useful life
  - all subsequent changes in the liability shall be recognised in profit or loss as they occur.
- This applies under both the cost model and the revaluation model.



4. Consensus

Changes resulted from
Passage of Time

- The periodic unwinding of the discount shall be
  - recognised in profit or loss as a finance cost as it occurs.
- The allowed alternative treatment of capitalisation under IAS 23 is not permitted.

4. Consensus – Case

Case

Royal Dutch/Shell explained its group accounting policies under IFRS in respect of decommissioning as follows:

- Estimated decommissioning and restoration costs
  - are based on current requirements, technology and price levels and are stated at fair value, and the associated asset retirement costs are capitalised as part of the carrying amount of the related property, plant and equipment.
- The liability, once an obligation, whether legal or constructive, crystallises,
  - is recognised with a corresponding amount of property, plant and equipment in the period when a reasonable estimate of the fair value can be made.
- The fair value is calculated using amounts discounted over the useful economic life of the assets.
- The effects of changes resulting from revisions to the timing or the amount of the original estimate of the provision are incorporated on a prospective basis.

4. Consensus – Case

Case

Royal Dutch/Shell explained its group accounting policies under IFRS in respect of decommissioning as follows:

- Liabilities are determined independently of expected insurance recoveries.
  - Recoveries are recognised and reported as separate events and brought into account when reasonably certain of realisation.
- The carrying amount of provisions is regularly reviewed and adjusted for new facts or changes in law or technology.

Provisions, Contingent Liabilities and Contingent Assets (IAS 36)

8 April 2009

Full set of slides in PDF can be found in
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