FRS 102 - Provisions and contingencies

Over the last year I have examined various technical aspects concerning FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and I round off the 2014 analysis with provisions and contingencies which are dealt with in Section 21 *Provisions and Contingencies.* Section 21 contains a useful appendix which offers users a guide to recognising and measuring provisions.

The term 'provision' in the context of Section 21 is a liability which is of uncertain timing or amount. The scope section of Section 21 also recognises that the word 'provision' is used in another context representing a *provision for depreciation* or a *provision for bad debts*. These are adjustments to the carrying values of assets and uncollectible receivables as opposed to a provision for a liability which is what Section 21 is concerned with.

In addition to provisions, the Section is also concerned with contingencies. A 'contingency' is something which is dependent on the occurrence (or non-occurrence) of future events. Section 21 deals with both contingent assets and contingent liabilities and in real life practitioners often have difficulty in determining whether an event gives rise to a provision (and hence should be recognised in the financial statements) or a contingency (and hence disclosed where material).

The scope of Section 21 also applies to financial guarantee contracts, unless:

(a) the entity has chosen to apply IAS 39 *Financial Instruments: Recognition and Measurement* and/or IFRS 9 *Financial Instruments* to its financial instruments; or

(b) an entity has elected under FRS 103 *Insurance Contracts* to continue the application of insurance contract accounting.

There are certain issues which Section 21 does **not** cover and these are:

- Financial instruments (including loan commitments) which fall under the scope of Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instrument Issues*.
- Insurance contracts (including reinsurance contracts) which an entity may issue and reinsurance contracts which the entity holds, or financial instruments issued by an entity with a discretionary participation feature that fall under the scope of FRS 103.
- Executory contracts (unless these are onerous contracts).

Provisions

As discussed above, a provision is a liability of uncertain timing or amount. Before accounting standards which outlined the criteria that had to be met before a provision was recognised in the financial statements were issued, some entities were deliberately manipulating the profit and loss account through a practice which was known as 'big bath accounting'. 'Big bath accounting' was where an entity would make a very healthy profit in the year and management would reduce this profit by the creation of a provision for an expense. This was done primarily to stop shareholders from wanting a higher profit to be made in the succeeding financial year and so reduce the pressure placed on management. In the next financial year when profit was not as high, the provision would simply be reversed (either in full or in part). The focus, therefore, of management prior to the issuance of accounting standards on provisions was on the bottom line.

'Big bath accounting' (or 'big bath provisions' as they were then coined) were outlawed when accounting standards governing provisions and contingent assets and liabilities were introduced. Section 21 of FRS 102 requires three criteria to be met in order for a provision to be recognised which are:

(a) the entity has an obligation at the reporting date as a result of a past event;

(b) it is probable (that is, more likely than not) that the entity will be required to transfer economic benefits in settlement; and

(c) the amount of the obligation can be estimated reliably.

Where an entity cannot meet one, or more, of the above criteria, a provision must not be recognised but instead a contingent liability may need disclosure.

Example – uncertain obligation

Company A Ltd has been defending itself in legal proceedings brought against it by one of its customers who is alleging damage to her property. Work was carried out on the property by Company A Ltd on 2 July 2014 and the customer is alleging that damage to a wall occurred and that Company A's fitters caused the damage. The fitters claimed that the damage to the wall was already present.

Company A has a year-end of 31 October 2014 and the company has already incurred legal costs of £5,000 in defending the case and it is possible that further costs (estimated in the region of £10,000) could also be incurred after the court hearing. The financial controller is proposing to make a provision for this amount in the financial statements to 31 October 2014. The case is due to be heard on 12 December 2014 and Company A's lawyers have been unable to confirm whether the company will be successful in their defence.

Section 21 of FRS 102 requires the above three criteria to be met before a provision can be made within the financial statements. One of those criteria is that it is probable (that is, more likely than not) that the entity will be required to transfer economic benefits in settlement. Company A's legal advisers are unable to confirm one way or another as to the outcome of this case, therefore a provision should not be made because all three criteria in Section 21 cannot be made. As a result, disclosure as a contingent liability should be made within the financial statements.

Estimating a provision

Section 21 requires a provision to be recognised as a liability in the statement of financial position (balance sheet) with the corresponding debit being recognised in profit or loss as an expense. However, if another Section requires the cost to be recognised as part of the cost of an asset (for example, inventory or property, plant and equipment) then the debit is taken to the relevant area of the statement of financial position (balance sheet) rather than recognised in profit or loss.

Paragraph 21.7 of FRS 102 requires an entity to measure a provision at the 'best estimate' of the amount required to settle the obligation at the reporting date. In some cases the amount required to settle the obligation may well be known by the entity and hence a provision for the actual amount to be settled will be recognised. However, in some cases it might not be clear as to how much the provision should be and therefore professional judgement will have to be called upon. Paragraph 21.7(a) and (b) refers to provisions involving a large population of items and a single obligation respectively. Paragraph 21.7(a) says:

'When the provision involves a large population of items, the estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.'

Paragraph 21.7(b) says:

'When the provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation. However, even in such a case, the entity considers other possible outcomes. When other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.'

Example – estimating a warranty provision

Company B Ltd sells electrical goods which come with a standard warranty which covers customers in the event of any manufacturing defects which occur within six months of the customer purchasing the appliance. The year-end of Company B Ltd is 31 October 2014 and the directors have made assessments, based on past experience, as follows:

- If minor defects are detected in all products sold, the cost of the repairs will be £800,000.
- If major defects are detected in all products sold, the cost of the repairs will be £3 million.
- 70% of the goods sold are expected to have no defects, whilst 25% will have minor defects and the remaining 5% will have major defects.

The provision in respect of the warranties will be calculated as follows:

	£
70% x nil	nil
25% x £800,000	200,000
5% x £3,000,000	150,000
	350,000

Example – reimbursement

A firm of accountants has been sued by one of its clients for negligently preparing a corporation tax return. The case was settled after the balance sheet date and the firm made a provision for the actual amount settled in the year-end financial statements as all three criteria in Section 21 for a provision were met.

The accountancy firm's professional indemnity insurers have agreed to reimburse the amount claimed by the client and notification of this agreement was sent in writing to the firm a week before the year-end.

Paragraph 21.9 says that when some, or all, of the amount which is required to settle a provision is to be reimbursed by a third party, the entity shall recognise the reimbursement as a separate asset only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation. Amounts recognised as an asset in respect of reimbursements cannot exceed the amount of the provision. Therefore, the accountancy firm should recognise a receivable in respect of the amount due from the insurers.

In the above example, an accountancy firm should recognise a receivable representing the amounts due from its insurers. An important point to emphasise is that the receivable must **not** be offset against the provision – the two must be shown separately in the statement of financial position (balance sheet). However, in the income statement (profit and loss account), the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

Subsequent measurement of provisions

Paragraph 21.10 says that an entity shall only charge against a provision those expenditures for which the provision was originally recognised.

An entity is required to review its provisions at each reporting date and make adjustments to them to reflect the current best estimate of the amount which would be required to settle the obligation at that specific reporting date (note the term 'reporting date' is not restricted to the year-end). Where adjustments to the provision are necessary, they should be recognised in profit or loss. The exception to this is where the provision was originally recognised as part of the cost of an asset. Where the entity has recognised a provision at present value (that is, where the time value of money is material), the unwinding of the discount is recognised as a finance cost in profit or loss in the period in which it arises.

Example – future operating losses

One of Company C's largest customers has gone into liquidation following a downturn in the industry in which they both operate. Company C has made a provision for a bad debt in its year-end financial statements but has also adjusted its budgets for the forthcoming financial year as a result. The finance director has announced to the board that the first quarter of the new financial year is expected to make a heavy loss and the Chief Executive has suggested that in view of the fact that the year-end financial statements have yet to be approved, they can be adjusted to bring forward some of these losses into the year-end financial statements as a 'future operating loss' so that the first quarter of the new financial year is not looking quite as bad.

This accounting treatment would not be permissible because paragraph 21.11B says that provisions are not recognised for future operating losses and directs the user of FRS 102 to Example 1 of the appendix to Section 21.

Restructuring provisions

A 'restructuring' is defined in the Glossary to FRS 102 as:

'… 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.'

Paragraph 21.11C says that a restructuring will only give rise to a constructive obligation 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 starting to implement that plan or announcing its main features to those affected by it.

The entity must recognise a provision for restructuring costs only when it has a legal or constructive obligation at the reporting date to carry out the restructuring.

A 'constructive obligation' is defined in the Glossary to FRS 102 as:

'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.'

Contingencies

Section 21 distinguishes between a contingent liability and a contingent asset. A contingent liability is either a possible, but uncertain, obligation or a present obligation that is not recognised because it fails to meet the recognition criteria in paragraph 21.4, hence contingent liabilities are not recognised in the financial statements. The exception to this rule is in respect of provisions for contingent liabilities of an acquiree in a business combination.

Entities should make disclosures of a contingent liability unless the possibility of an outflow of resources is remote. In situations where an entity is jointly and severally liable for an obligation, the part of the obligation which is expected to be met by other parties is a contingent liability.

Like with contingent liabilities, a contingent asset is not recognised in the financial statements. Disclosure of a contingent asset is required by Section 21 when the inflow of economic benefits is probable. An asset is not contingent when its receipt is virtually certain and hence in this situation recognition in the financial statements is appropriate.

Disclosure requirements

There are five classes of disclosure requirements in Section 21:

- Disclosures about provisions;
- Disclosures about contingent liabilities;
- Disclosures about contingent assets;
- Prejudicial disclosures; and
- Disclosure about financial guarantee contracts.

Disclosures about provisions

In respect of each class of provision, the entity should disclose:

a) a reconciliation showing:
    i. the carrying amount at the beginning and end of the period;
    ii. additions during the period, including adjustments that result from changes in measuring the discounted amount;
    iii. amounts charged against the provision during the period; and
    iv. unused amounts reversed during the period;
b) a brief description of the nature of the obligation and the expected amount and timing of any resulting payments;
c) an indication of the uncertainties about the amount or timing of those outflows; and
d) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

It is to be noted that comparative information is not required for prior periods in respect of the above disclosures.

Disclosures about contingent liabilities

Where the probability of any outflow of resources is not remote, the entity must disclose a brief description of the nature of the contingent liability and, where practicable:

a) an estimate of its financial effect, measured in accordance with paragraphs 21.7 to 21.11;
b) an indication of the uncertainties relating to the amount or timing of any outflow; and
c) the possibility of any reimbursement.

Where it is considered impracticable to make one, or more, of the above disclosures that fact is to be stated.

Disclosures about contingent assets

For contingent assets, the entity should disclose a description of the nature of the contingent assets and, when practicable, an estimate of their financial effect, measured using the principles in paragraphs 21.7 to 21.11. Where it is considered impracticable to make this disclosure, that fact should be stated.

Prejudicial disclosures

In extremely rare cases, disclosure of the above can be expected to prejudice seriously the position of an entity in a dispute with other parties on the subject matter of the provision or contingency. In such cases the entity does not need to disclose the above information but instead will disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Disclosure about financial guarantee contracts

For financial guarantee contracts, the entity is to disclose the nature and business purpose of the financial guarantee contracts it has issued. Where applicable the disclosures required in respect of provisions and contingent liabilities should also be made.

Conclusion

This article concludes the 2014 examination of FRS 102 and in 2015 I will continue to examine the content of the new reporting regime including the changes proposed to the small companies' financial reporting regime. I would like to wish all readers a Happy Christmas and a prosperous New Year and hope that you have found this year's articles on FRS 102 helpful and informative.