Provisions, Contingent Liabilities and Contingent Assets (IAS 37)

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1. Purpose and Scope of IAS 37

IAS 37 governs how entities recognise, measure and disclose **provisions**, **contingent liabilities**, and **contingent assets**. Its core purpose is to ensure that liabilities are recognised **only when they genuinely exist**, and that financial statements do not hide obligations or overstate assets.

IAS 37 applies to **all entities** and **all types of provisions**, except those covered by other standards (e.g., IFRS 9 for financial instruments, IFRS 3 for contingent consideration in business combinations, IAS 19 for employee benefits).

2. Key Definitions (Defined on First Use)

2.1 Liability

A *present obligation* of the entity arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits (CF).

2.2 Provision

A **liability of uncertain timing or amount**. This uncertainty distinguishes provisions from trade payables or accruals.

2.3 Contingent Liability

Either:

- A **possible obligation** arising from past events, whose existence will be confirmed only by uncertain future events not wholly within the entity's control; **or**
- A **present obligation** that is *not recognised* because:
    - it is **not probable** that an outflow of resources will be required, **or**
    - the amount **cannot be measured reliably**.

2.4 Contingent Asset

A **possible asset** arising from past events, whose existence will be confirmed only by uncertain future events not wholly within the entity's control.

3. Provisions — Recognition Criteria

A provision is recognised **only when all three conditions are met**:

Condition 1: Present Obligation

The entity must have a **legal obligation** (law, contract) or a **constructive obligation** (valid expectation created by past practice, published policies, or specific statements).

Condition 2: Probable Outflow

It must be **probable** (more likely than not) that an outflow of resources will be required.

Condition 3: Reliable Estimate

The amount must be capable of being **estimated reliably**.

If **any** of these three criteria are not met → **no provision** is recognised.

4. Present Obligations: Legal vs Constructive

4.1 Legal Obligations

Arise from:

- Contracts
- Legislation
- Statutory requirements
- Court rulings

4.2 Constructive Obligations

Arise when the entity's actions create a **valid expectation** that it will discharge certain responsibilities. This usually results from:

- Established patterns of past practice
- Public announcements
- Published policies

Example: A retailer has a long-standing practice of refunding customers even when not legally required. Customers expect refunds. This creates a **constructive obligation**.

5. Measurement of Provisions

Provisions are measured at the **best estimate** of the expenditure required to settle the obligation at the reporting date.

5.1 Best Estimate

The amount an entity would rationally pay to settle the obligation or transfer it to a third party.

5.2 Expected Value Method

Used when there is a range of possible outcomes. Weighted probabilities are applied.

5.3 Single Most Likely Outcome

Used when the obligation relates to a single item (e.g., a lawsuit).

5.4 Risks and Uncertainties

Adjustments must be made for risks and uncertainties that affect the amount.

5.5 Present Value (Discounting)

If the effect of time value of money is **material**, the provision must be **discounted** using a **pre-tax discount rate** reflecting current market assessments.

5.6 Future Events

Future events that may affect the amount (e.g., new technology reducing costs) are considered **only if there is objective evidence** they will occur.

6. Reimbursements

If another party is expected to reimburse some or all of the expenditure (e.g., insurance), the reimbursement is recognised **only when it is virtually certain**.

The reimbursement is recognised as a **separate asset**, not netted off against the provision.

7. Changes in Provisions

Provisions must be **reviewed at each reporting date** and adjusted to reflect the current best estimate.

If an outflow is no longer probable → the provision is **reversed**.

8. Specific Types of Provisions

8.1 Onerous Contracts

A contract is onerous when the **unavoidable costs** of meeting the obligations exceed the **economic benefits** expected.

Provision = *Lower of*

- cost of fulfilling the contract, and
- compensation/penalty for exiting the contract.

8.2 Restructuring Provisions

Recognised only when the entity has:

1. A **detailed formal plan**, and
2. A **valid expectation** created by announcing the plan or starting implementation.

A restructuring provision includes only **direct expenditures** arising from the restructuring — not future operating losses or costs of retraining or relocating staff.

8.3 Decommissioning / Restoration Provisions

Often arise in extractive industries. Initial estimate is added to the **cost of the related asset** and depreciated over its useful life.

8.4 Environmental Provisions

Recognised when legislation or constructive obligations require clean-up or environmental restoration.

8.5 Warranty Provisions

Recognised based on past experience of warranty claims.

9. Contingent Liabilities

Contingent liabilities are **not recognised**, but **disclosed**, unless the possibility of outflow is **remote**.

Disclosure must include:

- Nature of the contingency
- Estimate of financial effect
- Uncertainties
- Possibility of reimbursement

10. Contingent Assets

Contingent assets are **not recognised** because this would result in recognising income that may never be realised.

They are **disclosed** only when an inflow of economic benefits is **probable**.

If the inflow becomes **virtually certain**, the asset is **no longer contingent** and is recognised.

11. Future Operating Losses

Future operating losses **must not** be recognised as provisions. They do not arise from past events and therefore do not meet the definition of a liability.

12. Executory Contracts

An executory contract is one in which **neither party has performed**. No provision is recognised unless the contract is **onerous**.

13. Detailed Examples

Example 1: Warranty Provision

A company sells 10,000 kettles with a one-year warranty. Past experience shows 2% of kettles require replacement at a cost of R150 each.

Provision = 10,000 × 2% × R150 → Provision = **R30,000**

Example 2: Lawsuit (Single Outcome)

A customer sues the company for R500,000. Legal advisors say the company will probably lose and estimate damages at R300,000.

Provision = **R300,000**

Example 3: Environmental Clean-Up (Discounted)

A mine must restore land in 5 years. Estimated cost: R2,000,000 Discount rate: 8%

Present value = R2,000,000 ÷ $(1.08)^5$ → Present value ≈ **R1,361,000**

Provision recognised = R1,361,000 This amount is added to the cost of the mining asset.

Example 4: Onerous Contract

A company has a contract to supply goods for R500,000. Unavoidable cost of fulfilling the contract is R650,000.

Provision = **R150,000**

Example 5: Restructuring

A company announces a plan to close a division and communicates this to employees. Costs include:

- Termination benefits: R1,200,000
- Penalties for lease cancellation: R300,000
- Retraining staff for other divisions: R200,000 (not included)

Provision = R1,200,000 + R300,000 Provision = **R1,500,000**

14. Disclosure Requirements

Provisions

For each class of provision, disclose:

- Carrying amount at start and end
- Additional provisions made
- Amounts used
- Unused amounts reversed
- Description of nature and timing
- Major uncertainties
- Reimbursements

Contingent Liabilities

Disclose unless outflow is remote.

Contingent Assets

Disclose only when inflow is probable.

15. Decision Trees for Provisions vs Contingencies

1. Master Decision Tree: Is it a Provision, Contingent Liability, or Nothing?

```
START
|
├─▶ Has a past event created an obligation?
|      |
|      ├─▶ NO → No provision. No contingent liability. STOP.
|      |
|      └─▶ YES → Continue.
|
├─▶ Is the obligation present (legal or constructive)?
|      |
|      ├─▶ NO → Possible obligation → Contingent liability (disclose if not remote). STOP.
|      |
|      └─▶ YES → Continue.
|
├─▶ Is an outflow of economic benefits PROBABLE (>50%)?
|      |
|      ├─▶ NO → Present obligation but outflow not probable → Contingent liability (disclose). STOP.
|      |
|      └─▶ YES → Continue.
|
├─▶ Can the amount be measured reliably?
|      |
|      ├─▶ NO → Contingent liability (disclose). STOP.
|      |
|      └─▶ YES → Provision (recognise). STOP.
```

2. Decision Tree: Identifying a Present Obligation

```
START
|
├─▶ Is there a legal obligation?
|       |
|        ├─▶ YES → Present obligation exists. Continue.
|       └─▶ NO → Check constructive obligation.
|
├─▶ Has the entity created a valid expectation through:
|       - past practice?
|       - published policies?
|       - specific public statements?
|
|       |
|        ├─▶ YES → Constructive obligation exists → Present obligation.
Continue.
|       └─▶ NO → No present obligation → Possible obligation only →
Contingent liability.
```

3. Decision Tree: Measuring a Provision

```
START
|
├─▶ Is the obligation a single item (e.g., lawsuit)?
|       |
|        ├─▶ YES → Use "most likely outcome" as best estimate.
|       └─▶ NO → Use "expected value" (probability-weighted outcomes).
|
├─▶ Are risks and uncertainties significant?
|       |
|        ├─▶ YES → Adjust estimate for risk.
|       └─▶ NO → Use unadjusted estimate.
|
├─▶ Is the settlement long-term and discounting material?
|       |
|        ├─▶ YES → Discount using pre-tax market rate.
|       └─▶ NO → No discounting.
|
└─▶ Final amount = Best estimate of expenditure required to settle obligation.
```

4. Decision Tree: Onerous Contracts

```
START
|
├─► Is the contract executory (neither party has performed)?
|       |
|       ├─► NO → Not an onerous contract assessment. STOP.
|       └─► YES → Continue.
|
├─► Are the unavoidable costs of fulfilling the contract > economic benefits?
|       |
|       ├─► NO → Contract is not onerous → No provision.
|       └─► YES → Contract is onerous → Recognise provision.
|
└─► Provision amount = Lower of:
       - cost of fulfilling contract
       - cost of exiting contract (penalties/compensation)
```

5. Decision Tree: Restructuring Provisions

```
START
|
├─► Is there a detailed formal restructuring plan?
|       |
|       ├─► NO → No provision.
|       └─► YES → Continue.
|
├─► Has the plan been announced or implementation begun?
|       |
|       ├─► NO → No constructive obligation → No provision.
|       └─► YES → Constructive obligation exists → Continue.
|
├─► Are the costs directly related to the restructuring?
|       |
|       ├─► YES → Include in provision.
|       └─► NO → Exclude (e.g., future operating losses, retraining).
|
└─► Recognise restructuring provision.
```

6. Decision Tree: Contingent Liabilities

```
START
|
├─▶ Is there a possible obligation?
|       |
|       ├─▶ YES → Contingent liability → Disclose unless remote.
|       └─▶ NO → Continue.
|
├─▶ Is there a present obligation but:
|       - outflow NOT probable, OR
|       - amount NOT measurable reliably?
|
|       |
|       ├─▶ YES → Contingent liability → Disclose unless remote.
|       └─▶ NO → If probable + measurable → Provision.
```

7. Decision Tree: Contingent Assets

```
START
|
├─▶ Is there a possible asset from past events?
|       |
|       ├─▶ NO → No contingent asset.
|       └─▶ YES → Continue.
|
├─▶ Is inflow of economic benefits PROBABLE?
|       |
|       ├─▶ NO → Do not disclose.
|       └─▶ YES → Disclose contingent asset.
|
├─▶ Is inflow VIRTUALLY CERTAIN?
|       |
|       ├─▶ YES → Recognise asset (no longer contingent).
|       └─▶ NO → Keep as contingent asset (disclose only).
```

8. Decision Tree: Reimbursements

```
START
|
├─► Is reimbursement from another party virtually certain?
|      |
|      ├─► NO → Do not recognise reimbursement asset.
|      └─► YES → Recognise separate reimbursement asset.
|
└─► Note: Do NOT net off against provision. Present separately.
```

9. Decision Tree: Future Operating Losses

```
START
|
├─► Are the losses related to future operations?
|      |
|      ├─► YES → No provision (not a liability).
|      └─► NO → Continue.
|
└─► If related to past events → assess under normal provision criteria.
```

10. Decision Tree: Executory Contracts

```
START
|
├─► Is the contract executory?
|      |
|      ├─► NO → Not an executory contract → Apply other IFRS.
|      └─► YES → Continue.
|
├─► Is the contract onerous?
|      |
|      ├─► NO → No provision.
|      └─► YES → Recognise provision (onerous contract).
|
```

16. 20-Question MCQ Exam Pack

Multiple-Choice Questions

1. A provision is recognised when:

A. There is a possible obligation, and an outflow is remote
B. There is a present obligation, probable outflow, and reliable estimate
C. There is a present obligation, but outflow is not probable
D. There is a future operating loss expected

2. A contingent liability is:

A. Always recognised
B. Never disclosed
C. Recognised only when probable
D. A possible obligation or a present obligation not recognised

3. A constructive obligation arises from:

A. Legislation only
B. Court rulings only
C. Past practice, published policies, or public statements
D. Future intentions

4. A contingent asset is recognised when:

A. Inflow is probable
B. Inflow is virtually certain
C. Inflow is possible
D. Inflow is remote

5. Provisions must be measured at:

A. The lowest possible amount
B. The highest possible amount
C. The best estimate of expenditure required
D. The average of all possible outcomes

6. Discounting of provisions is required when:

A. The effect of time value of money is material
B. The provision is less than one year
C. The provision relates to warranties
D. The entity chooses to discount voluntarily

7. A restructuring provision includes:

A. Future operating losses
B. Retraining costs
C. Direct costs arising from the restructuring
D. Costs of relocating staff

8. An onerous contract arises when:

A. The contract is profitable
B. The unavoidable costs exceed economic benefits
C. The entity expects future losses
D. The contract is executory

9. Future operating losses:

A. Are recognised as provisions
B. Are disclosed as contingent liabilities
C. Are recognised only if probable
D. Are never recognised as provisions

10. Reimbursements are recognised when:

A. They are probable
B. They are virtually certain
C. They are possible
D. They are remote

11. A lawsuit with a probable loss and reliably measurable amount should be:

A. Ignored
B. Disclosed only
C. Recognised as a provision
D. Recognised as a contingent asset

12. A warranty obligation is an example of:

A. A contingent liability
B. A provision
C. A contingent asset
D. A future operating loss

13. A contingent liability is disclosed unless:

A. The outflow is probable
B. The outflow is remote
C. The amount is measurable
D. The obligation is legal

14. Executory contracts give rise to provisions only when:

A. They are profitable
B. They are onerous
C. They are long-term
D. They involve legal obligations

15. A provision must be reversed when:

A. The amount increases
B. The outflow is no longer probable
C. The discount rate changes
D. The obligation becomes legal

16. The best estimate for a single obligation (e.g., lawsuit) is:

A. Expected value
B. Most likely outcome
C. Minimum amount
D. Maximum amount

17. A decommissioning provision is initially:

A. Expensed immediately
B. Added to the cost of the related asset
C. Recognised as a contingent liability
D. Disclosed only

18. A contingent asset is disclosed when:

A. Inflow is probable
B. Inflow is virtually certain
C. Inflow is possible
D. Inflow is remote

19. A present obligation exists when:

A. There is a legal or constructive obligation
B. The entity expects future losses
C. The entity plans to restructure
D. The entity has signed a contract but not performed

20. A provision for an onerous contract equals:

A. Total contract value
B. Total unavoidable costs
C. Lower of fulfilment cost and exit cost
D. Higher of fulfilment cost and exit cost

MCQ Answer Key

Answer Key

1. B
2. D
3. C
4. B
5. C
6. A
7. C
8. B
9. D
10. B
11. C
12. B
13. B
14. B
15. B
16. B
17. B
18. A
19. A
20. C

17. Case-Study-Based Long-Form Exam

Case Study: KuduTech Manufacturing (Pty) Ltd

KuduTech is a South African electronics manufacturer producing smart home devices. The company is preparing its financial statements for the year ended **31 December 20X5**. The CFO has identified several matters that may require recognition or disclosure under **IAS 37: Provisions, Contingent Liabilities and Contingent Assets**.

You are the financial reporting specialist assigned to evaluate each matter.

Required:

Analyse the following scenarios and determine, with justification, whether KuduTech must recognise a provision, disclose a contingent liability, disclose a contingent asset, or take no action. Provide calculations where required.

Scenario 1 — Warranty Obligations (6 marks)

KuduTech offers a **two-year warranty** on all smart thermostats sold. During 20X5, the company sold **120,000 units**. Based on past experience:

- 3% of units require minor repairs costing **R180** each.
- 1% require full replacement costing **R650** each.

The CFO argues that the warranty is “just marketing” and should not be recognised as a liability.

Required:

Determine whether a provision is required and calculate the amount. Explain your reasoning with reference to IAS 37.

Scenario 2 — Lawsuit from Supplier (10 marks)

A supplier alleges that KuduTech breached a long-term supply contract and is suing for **R4.5 million** in damages.

Legal advisors have provided the following assessment:

- There is a **70% probability** KuduTech will lose.
- If KuduTech loses, damages are estimated at **R3 million**.
- If KuduTech wins, no payment is required.
- The case will only be resolved in 20X7.

The CFO wants to disclose the matter only, arguing that “nothing is certain yet.”

Required:

Assess whether KuduTech must recognise a provision or disclose a contingent liability. Provide calculations and justification.

Scenario 3 — Environmental Restoration (8 marks)

KuduTech operates a small chemical treatment facility. Environmental regulations require the company to restore the site at the end of its useful life. The facility has **five years** remaining.

Estimated restoration cost in five years: **R12 million** Appropriate pre-tax discount rate: **9%**

The CFO believes this should be recognised only when the restoration actually occurs.

Required:

Determine whether a provision must be recognised now and calculate the present value of the obligation. Explain your reasoning.

Scenario 4 — Restructuring Announcement (10 marks)

On **15 December 20X5**, KuduTech's board approved a detailed plan to close its IoT Router Division. On **20 December**, the plan was formally announced to employees and customers.

The restructuring plan includes:

- Termination benefits for 45 employees: **R4.2 million**
- Penalties for early cancellation of supplier contracts: **R1.1 million**
- Retraining costs for employees being moved to other divisions: **R900,000**
- Marketing costs to rebrand remaining divisions: **R600,000**

Implementation will begin in **February 20X6**.

Required:

Determine which costs, if any, should be included in a restructuring provision at 31 December 20X5. Provide justification.

Scenario 5 — Onerous Contract (8 marks)

KuduTech signed a contract to supply 10,000 smart sensors to a retailer at **R220 per unit**. Due to a component shortage, the unavoidable cost of fulfilling the contract has increased to **R260 per unit**.

Alternatively, KuduTech may exit the contract by paying a penalty of **R350,000**.

Required:

Determine whether the contract is onerous and calculate the provision amount.

Scenario 6 — Insurance Reimbursement (6 marks)

A fire damaged one of KuduTech's warehouses. The company expects to incur **R2.8 million** in repair costs. The insurance company has **confirmed in writing** that it will reimburse **80%** of the repair costs, but payment will only be made after inspection in March 20X6.

Required:

Determine how the repair costs and reimbursement should be recognised or disclosed at 31 December 20X5.

Scenario 7 — Possible Patent Compensation (7 marks)

KuduTech developed a new sensor technology. A competitor has been using similar technology without permission. KuduTech's lawyers believe:

- There is a **40% probability** KuduTech will win compensation of **R5 million**.
- There is a **60% probability** the case will fail.

The CFO wants to recognise an asset because "we will probably win something."

Required:

Determine whether KuduTech should recognise an asset, disclose a contingent asset, or do nothing. Justify your answer.

Scenario 8 — Future Operating Losses (5 marks)

The CFO expects the Router Division (from Scenario 4) to incur operating losses of **R3.5 million** during the first half of 20X6, before closure is complete.

He wants to include these losses in the restructuring provision.

Required:

Explain whether future operating losses may be included in a provision under IAS 37.

Scenario 9 — Executory Contract (5 marks)

KuduTech has a contract to purchase components from a supplier at fixed prices for the next 18 months. Neither party has performed yet. Market prices have fallen, and the CFO wants to recognise a provision for the "expected loss."

Required:

Determine whether a provision is required under IAS 37.

Scenario 10 — Customer Refund Policy (10 marks)

Although not legally required, KuduTech has a long-standing practice of offering **full refunds** to dissatisfied customers within 30 days. This policy is widely advertised and consistently applied.

During 20X5, KuduTech sold **R85 million** worth of products. Based on past experience, **2%** of customers request refunds.

Average refund amount: **R1,700**

Required:

Determine whether this creates a constructive obligation and calculate any required provision.

MODEL ANSWER MEMO

Scenario 1 — Warranty Obligations (6 marks)

Issue: Whether the two-year warranty creates a present obligation requiring a provision.

IAS 37 Principles Applied:

- A warranty creates a **legal obligation** arising from past sales.
- A provision is recognised when:
    1. Present obligation exists
    2. Outflow is probable
    3. Amount can be reliably estimated
- Warranty provisions are classic examples of provisions.

Calculation:

Minor repairs: 120,000 × 3% × R180 = **R648,000**

Full replacements: 120,000 × 1% × R650 = **R780,000**

Total warranty provision = R1,428,000

Conclusion:

A provision **must be recognised**. The CFO’s argument is incorrect — warranties are not “marketing”; they are obligations.

Scenario 2 — Lawsuit from Supplier (10 marks)

Issue: Whether the lawsuit requires a provision or only disclosure.

IAS 37 Principles Applied

- Probability of losing = 70% → **probable** outflow.
- Amount is reliably measurable (R3 million).
- Therefore, all three recognition criteria are met.

Calculation:

Provision = **R3,000,000** (most likely outcome for a single obligation)

Conclusion:

Recognise a **provision of R3 million**. Disclosure alone is insufficient.

Scenario 3 — Environmental Restoration (8 marks)

Issue: Whether a decommissioning/restoration obligation must be recognised now.

IAS 37 Principles Applied:

- Legal obligation exists due to environmental regulations.
- Obligation arises from **past operations**, not future actions.
- Must recognise a provision and **discount** if material.

Calculation:

Present value = R12,000,000 ÷ $(1.09)^5 \approx 1.53862$ → PV ≈ **R7,800,000** (rounded)

Conclusion:

Recognise a **provision of approximately R7.8 million**. Add this amount to the cost of the related asset.

Scenario 4 — Restructuring Announcement (10 marks)

Issue:

Which restructuring costs qualify for inclusion in a provision.

IAS 37 Principles Applied:

A restructuring provision is recognised only when:

- A detailed plan exists, **and**
- A valid expectation is created (announcement made).

Only **direct expenditures** arising from the restructuring are included.

Assessment of Costs:

- Termination benefits → **Included**
- Contract cancellation penalties → **Included**
- Retraining costs → **Excluded** (future operating costs)
- Marketing/rebranding → **Excluded** (not directly caused by restructuring)

Calculation:

Provision = R4.2m + R1.1m = **R5.3 million**

Conclusion:

Recognise a **R5.3 million restructuring provision**.

Scenario 5 — Onerous Contract (8 marks)

Issue:

Whether the supply contract is onerous.

IAS 37 Principle Applied:

A contract is onerous when unavoidable costs exceed economic benefits.

Calculation:

Unavoidable fulfilment cost: 10,000 × R260 = **R2,600,000**

Contract revenue: 10,000 × R220 = **R2,200,000**

Loss if fulfilled = R400,000 Exit penalty = R350,000

Provision = **lower of fulfilment loss and exit cost** → Provision = **R350,000**

Conclusion:

Contract is **onerous**. Recognise a **provision of R350,000**.

Scenario 6 — Insurance Reimbursement (6 marks)

Issue:

How to treat repair costs and insurance reimbursement.

IAS 37 Principles Applied:

- Repair costs → present obligation → recognise provision/expense.
- Reimbursement recognised only when **virtually certain**.
- Insurer has confirmed in writing → meets "virtually certain".

Calculation:

Repair cost = R2.8m; Reimbursement = 80% × R2.8m = **R2.24m**

Conclusion:

Recognise:

- A **provision/expense of R2.8m**
- A **separate reimbursement asset of R2.24m.** Do **not** net them off.

Scenario 7 — Possible Patent Compensation (7 marks)

Issue: Whether to recognise or disclose a contingent asset.

IAS 37 Principles Applied:

- Inflow probability = 40% → **not probable**.
- Contingent assets are disclosed only when inflow is **probable**.
- Recognised only when **virtually certain**.

Conclusion:

Do **nothing**. No recognition, no disclosure.

The CFO's proposal is incorrect.

Scenario 8 — Future Operating Losses (5 marks)

Issue:

Whether future operating losses may be included in a restructuring provision.

IAS 37 Principles Applied:

Future operating losses:

- Do **not** arise from past events
- Are therefore **not liabilities**
- Must **never** be included in provisions

Conclusion:

Future operating losses of R3.5m may **not** be included in the restructuring provision.

Scenario 9 — Executory Contract (5 marks)

Issue:

Whether an executory contract gives rise to a provision.

IAS 37 Principles Applied:

Executory contracts → no provision unless **onerous**. Market price changes do not create an obligation.

Conclusion:

No provision. Contract is executory but **not onerous**.

Scenario 10 — Customer Refund Policy (10 marks)

Issue:

Whether a constructive obligation exists.

IAS 37 Principles Applied:

A constructive obligation arises when:

- Entity has a consistent past practice
- Policy is advertised
- Customers have a valid expectation

All conditions are met → present obligation exists.

Calculation:

Refunds expected: 2% × R85,000,000 = R1,700,000

Average refund = R1,700; But the 2% already incorporates the average refund rate.

Provision = **R1,700,000**

Conclusion:

Recognise a **provision of R1.7 million** for customer refunds.
