

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 = $10,000 \times 2\% \times R150 \rightarrow$ 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 = $R2,000,000 \div (1.08)^5 \rightarrow$ Present value $\approx$ **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.

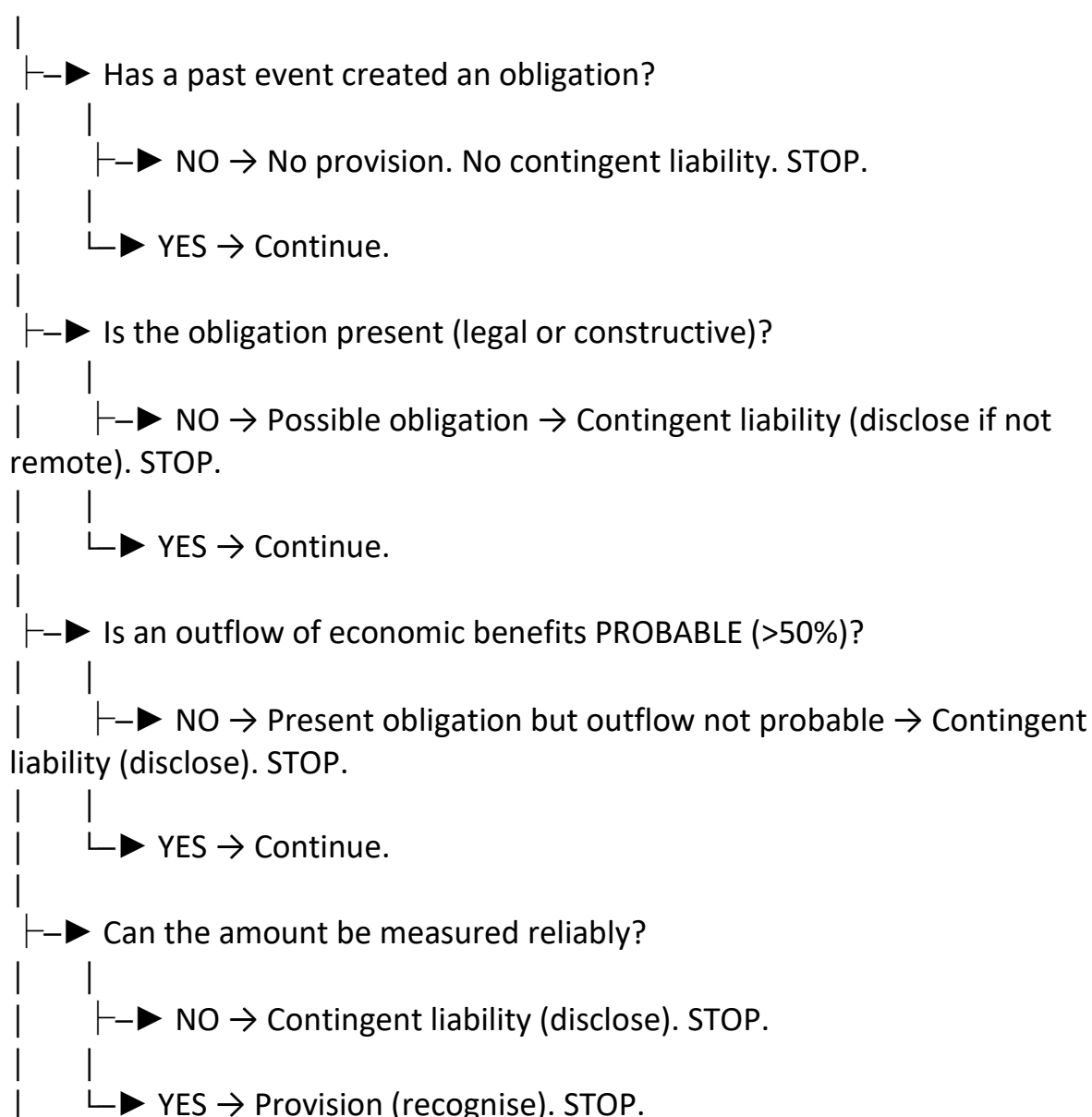
Contingent Assets

Disclose only when inflow is probable.

15. Decision Trees for Provisions vs Contingencies

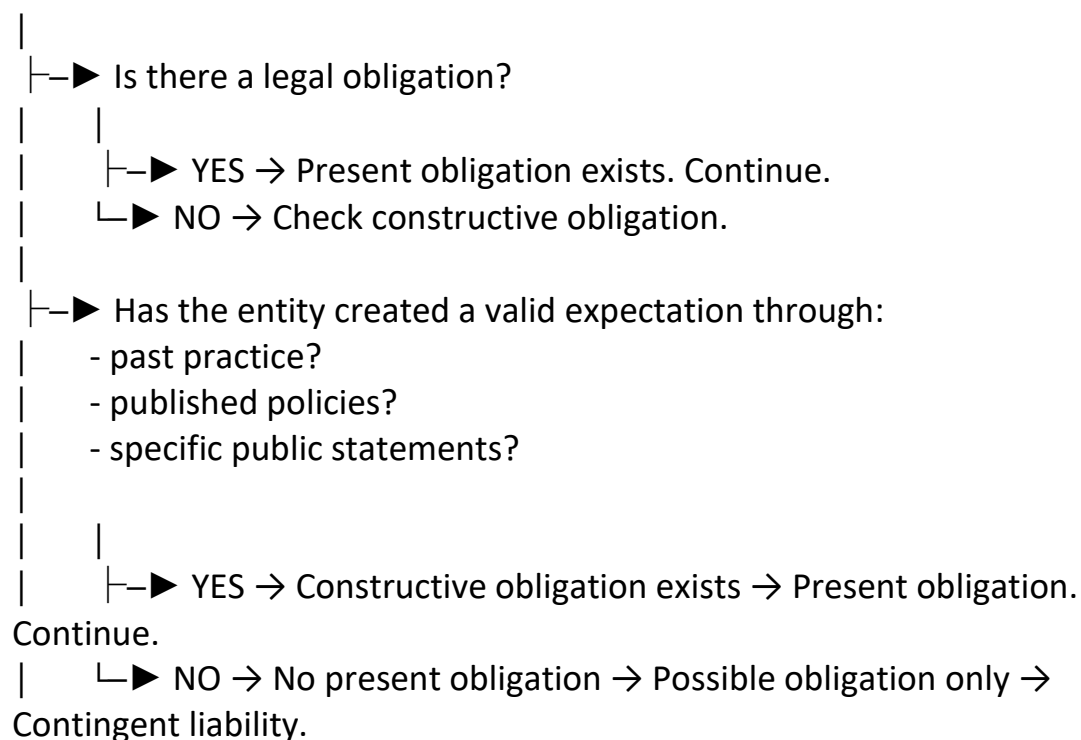
1. Master Decision Tree: Is it a Provision, Contingent Liability, or Nothing?

START



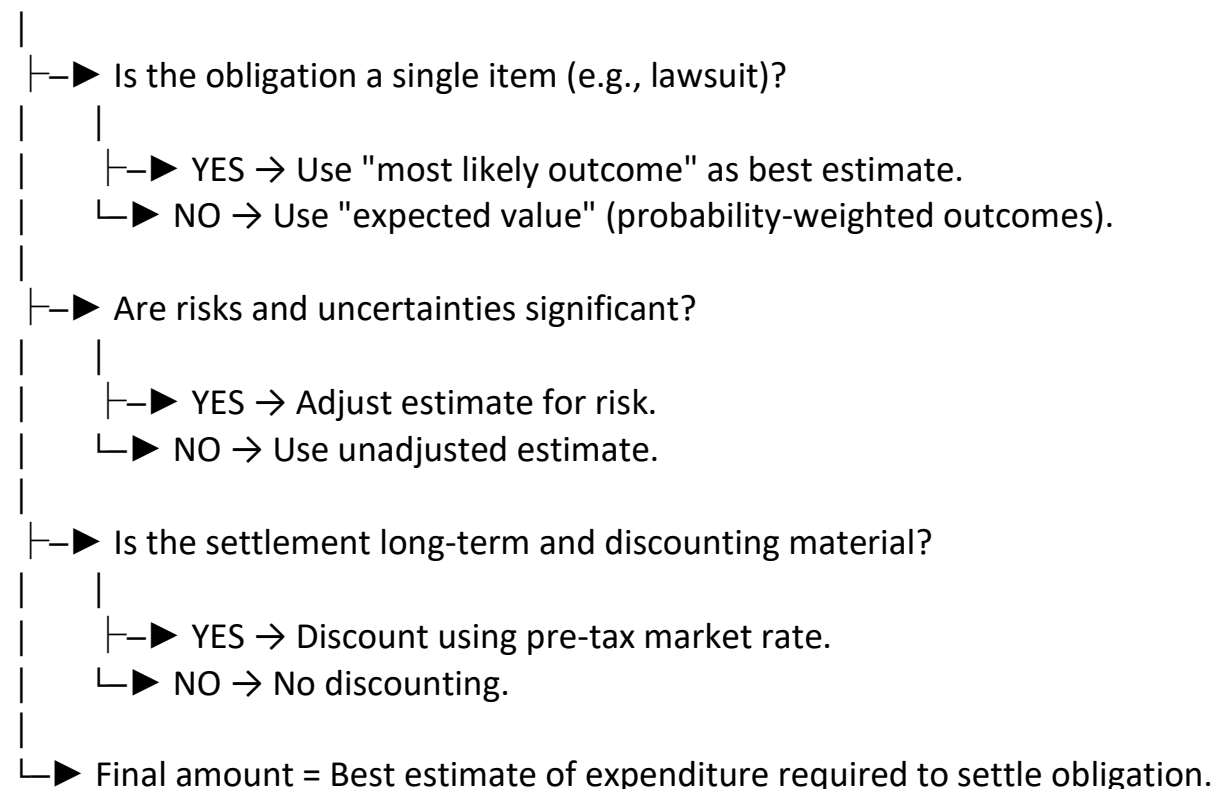
2. Decision Tree: Identifying a Present Obligation

START



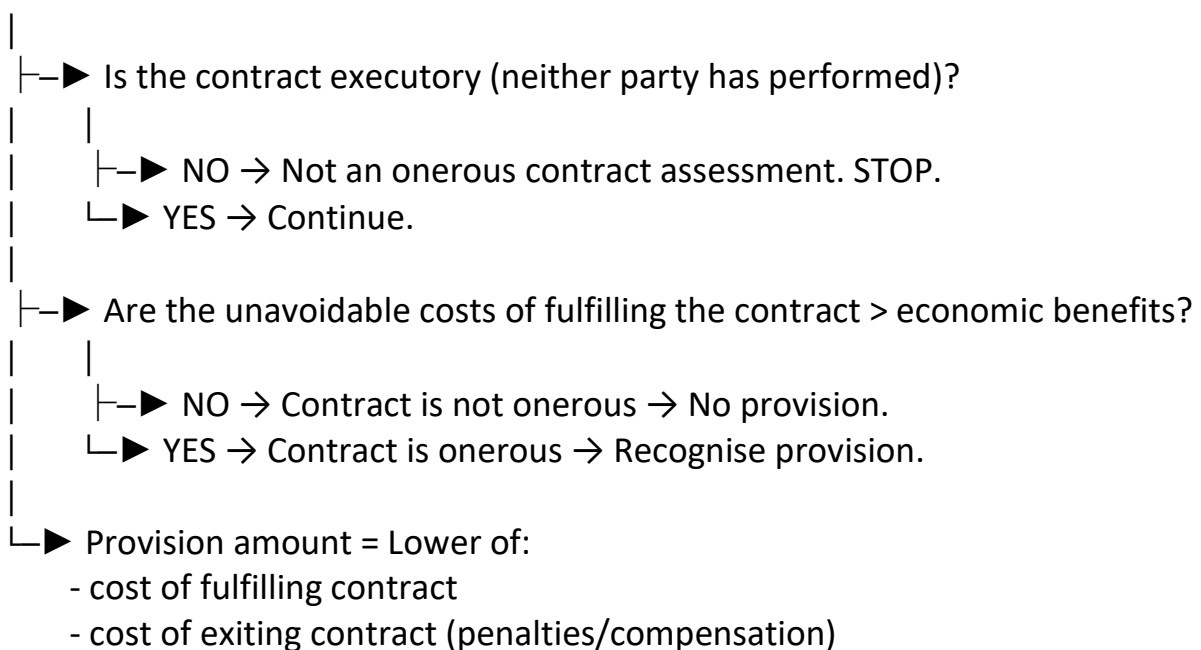
3. Decision Tree: Measuring a Provision

START



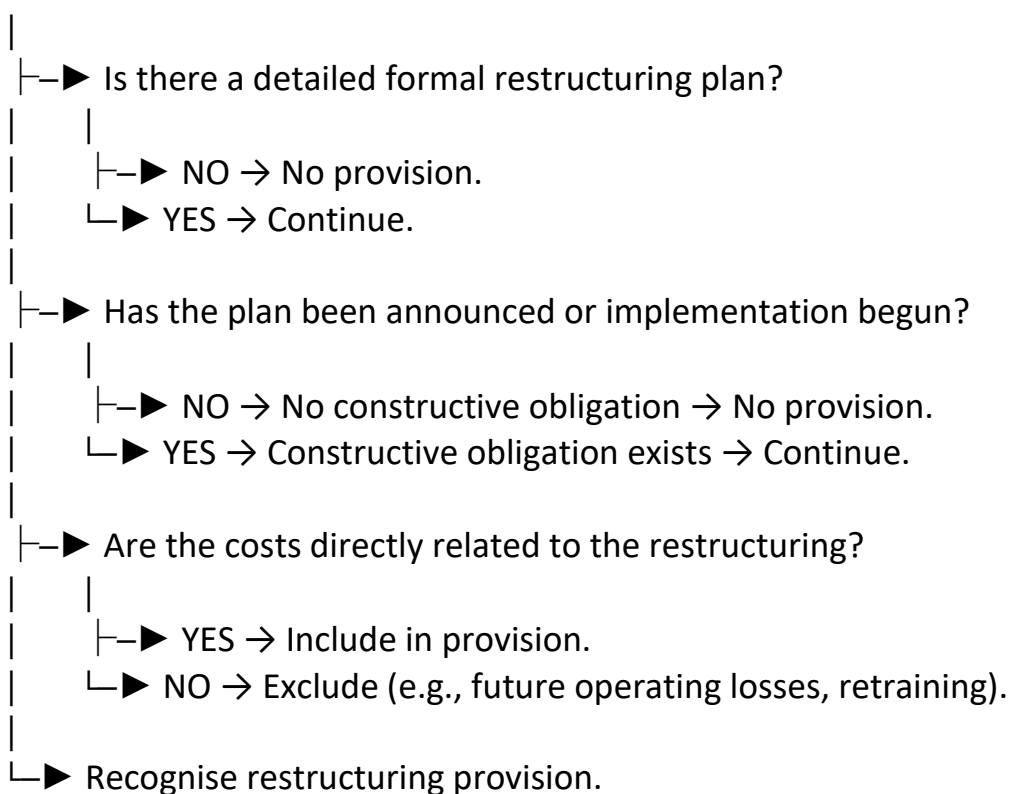
4. Decision Tree: Onerous Contracts

START



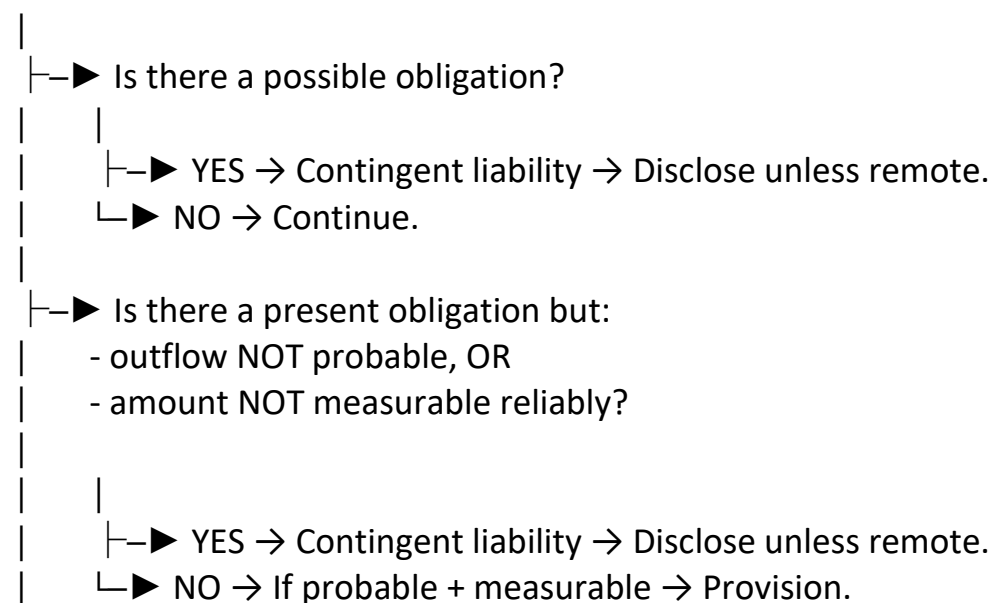
5. Decision Tree: Restructuring Provisions

START



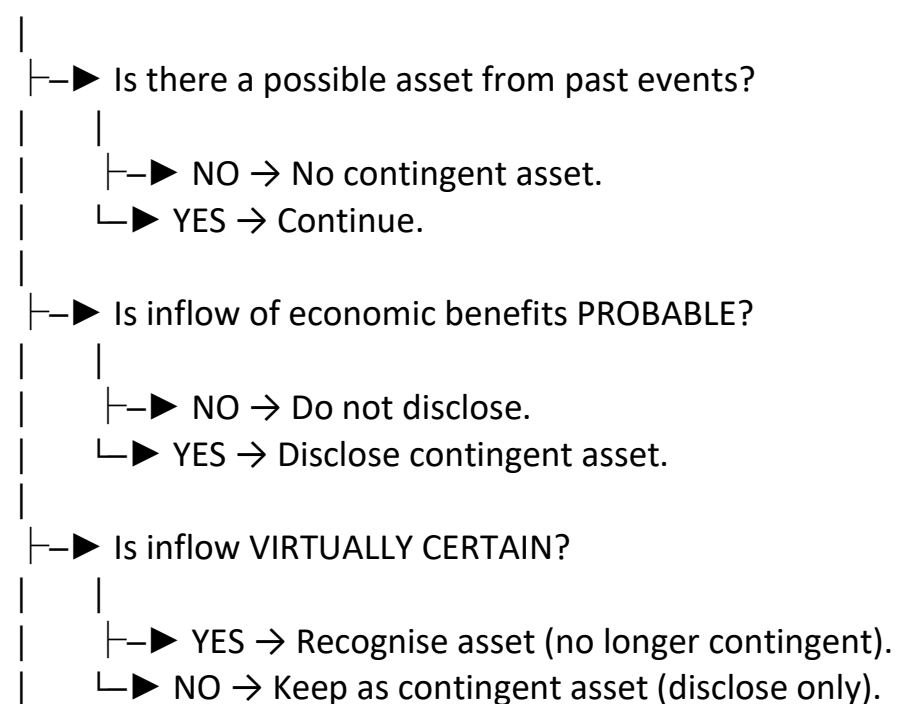
6. Decision Tree: Contingent Liabilities

START



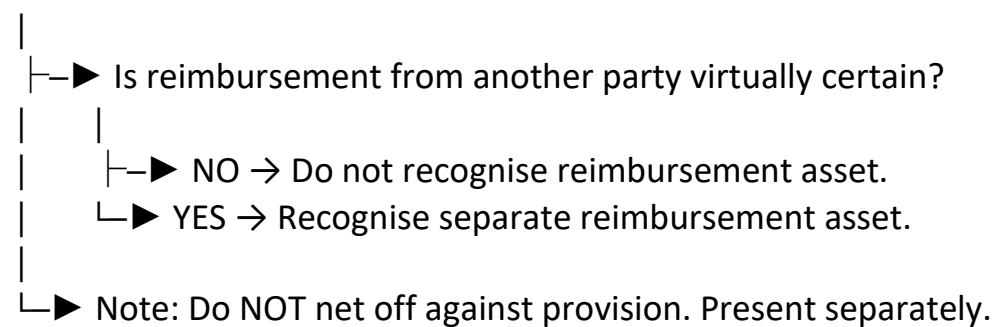
7. Decision Tree: Contingent Assets

START



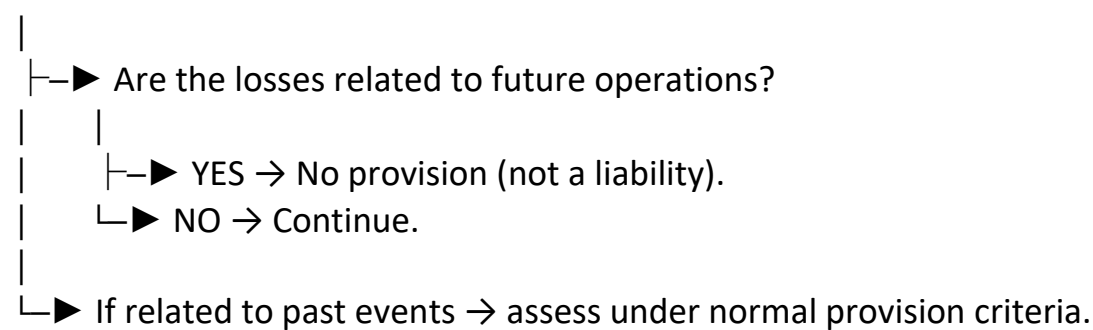
8. Decision Tree: Reimbursements

START



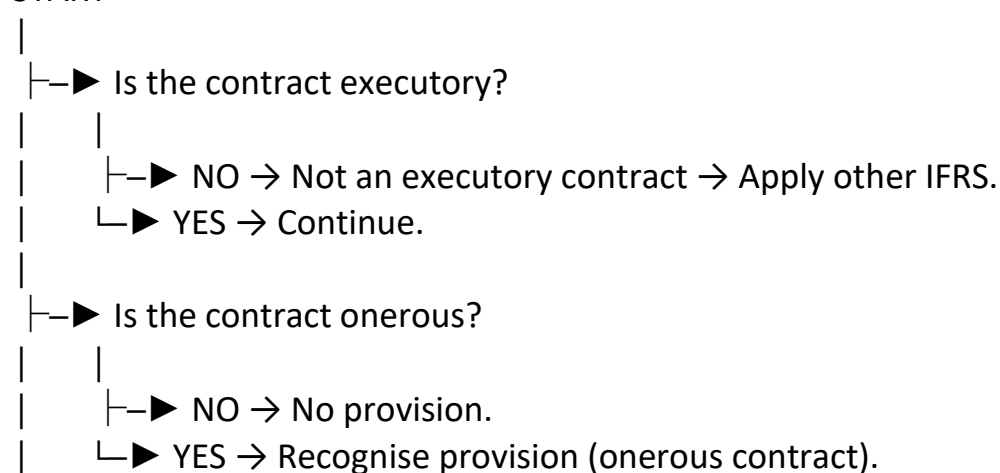
9. Decision Tree: Future Operating Losses

START



10. Decision Tree: Executory Contracts

START



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: $120,000 \times 3\% \times R180 = \mathbf{R648,000}$

Full replacements: $120,000 \times 1\% \times R650 = \mathbf{R780,000}$

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 = $R12,000,000 \div (1.09)^5 \approx 1.53862 \rightarrow PV \approx \mathbf{R7,800,000}$ (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: $10,000 \times R260 = \mathbf{R2,600,000}$

Contract revenue: $10,000 \times R220 = \mathbf{R2,200,000}$

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 = $80\% \times R2.8m = \mathbf{R2.24m}$

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: $2\% \times R85,000,000 = R1,700,000$

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.
