10. Provisions

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| **OVERVIEW** | * A provision is recognized on the basis of a legal or constructive obligation, if there is a probable outflow of resources and the amount can be estimated reliably. * A provision is measured at the best estimate of the anticipated outflow of resources. * Provisions are discounted if the effect thereof is material. * A provision for restructuring costs is not recognized until there is a formal plan and details of the restructuring have been communicated to those affected by the plan. * A provision for onerous contracts should be recognized when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract. * Provisions are not recognized for repairs or maintenance of owned assets. |

10.1 Purpose and scope

This policy provides guidance and rules on accounting for provisions for the purpose of preparing the financial statements of the Group according to International Financial Reporting Standards.

Furthermore, this section does not provide guidance on the accounting for provisions related to employee benefits. *Please refer to Employee benefits.*

10.2 Definitions

A **provision** is a liability of uncertain timing or amount.

A **liability** is a present obligation that arises from past events, which is expected to result in the outflow of the Group’s resources upon settlement.

**Accruals** are liabilities to pay for goods or services that have been received or supplied but not yet paid or invoiced. The uncertainty of timing and amount generally is less for an accrual than for a provision. Accruals are reported as part of trade and other payables, whereas provisions are reported separately.

A **contingent liability** is 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 Group.

An **onerous contract** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

A **restructuring** is a program that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by the Group; or

(b) the manner in which that business is conducted

10.3 Recognition

A provision should be recognized when:

* there is a legal or constructive obligation arising from past events, or in cases of doubts as to the existence of an obligation (e.g., a court case), when it is more likely than not that a legal or constructive obligation has arisen from a past event; and
* it is more likely than not that there will be an outflow of benefits; and
* the amounts can be estimated reliably.

**Legal fees should be expensed as incurred in the period in which the legal services are rendered.**

10.3.1 Present obligation

An obligating event must arise from a past event.

For an event to be an obligating event, it is necessary that the Group has no realistic alternative to settling the obligation created by the event. This is the case only:

* where the settlement of the obligation can be enforced by law; or

in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the Group will discharge the obligation.

Expected future operating losses, even if probable, are not provided for (unless they relate to an onerous contract).

Legal obligation

Legal obligations normally arise from contracts or legislation. In practice, new legislation normally does not give rise to an obligation until it is enacted because of uncertainties with respect to both whether it will be enacted and its final terms.

Constructive obligation

A constructive obligation arises where the Group, by past practice or sufficiently detailed public statements, has created a valid expectation in other parties that it will carry out an action.

A management decision alone does not give rise to a constructive obligation, as it does not create a valid expectation in third parties until that decision is communicated to them. Therefore, a board decision does not trigger recognition of a provision.

10.3.2 Probable outflow of economic resources

For a liability to qualify for recognition there must be a present obligation and also the probability of an outflow of economic resources embodying economic benefits to settle that liability. 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 50%).

10.3.3 Reliable estimate

By using historical data (for example warranty claims), advice from outside legal counsel and experts, the Group will normally be able to determine a best estimate or a range of possible outcomes and therefore make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision.

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognized. In such instances the liability is disclosed as a contingent liability.

10.3.4 Contingencies

Contingent liability

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 recognized 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.

Contingent liabilities are not recognized, other than in connection with a business combination, and are only required to be disclosed in the ordinary course of business.

Contingent asset

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

Contingent assets are not recognized, but disclosed when an outflow of economic benefits is probable. When realization of a contingent asset is virtually certain (i.e. the probability that the event will occur is greater than 90%), it is no longer considered contingent and is recognized as an asset. For instance, expected reimbursements under an insurance contract are recognized as a separate receivable if they are virtually certain.

10.3.5 Illustration of recognition requirements

As an illustration of the recognition requirements set forth above, please consider the following diagram in deciding whether a provision should be recognized.



In practice, the percentages listed below should be used as an indication of the likelihood at which the inflow or outflow of economic benefits is expected to occur:

* Virtually certain: ≥ 90%
* Probable (more likely than not): > 50%
* Possible: ≤ 50%

Remote: ≤ 10%

10.4 Measurement

The amount provided should be the best estimate of the expenditure to be incurred at the balance sheet date. The estimates of outcome and financial effect are determined by the judgment of management, supplemented by experience of similar transactions and, in some cases from reports from independent experts.

10.4.1 Single obligation

If a single obligation is being measured, the most likely outcome usually is the best estimate.

Illustrative example:

If there is a 60 percent probability that the Group has to pay damages of $600,000 in a legal case, the provision is measured at $600,000 because P will either win (paying nothing) or lose and have to pay $600,000; not at $360,000 ($600,000 x 60% + 0 x 40%).

However, in some cases it will be necessary to consider other outcomes, even when a single obligation is measured.

10.4.2 Continuous range of possible outcomes

When 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.

Illustrative example:

The Group disputes a legal claim for which its lawyers advise that it is probable that it will be found liable. The amount that it should be required to pay in respect of this legal case could range from $100,000 to $150,000. The provision should be measured on the expected amount to be paid, which may be anywhere between $100,000 to $150,000. In this case the Group should record a provision for $125,000 (i.e. midpoint of the range) as each point in the range of possible outcomes is equally likely.

10.4.3 Large population

If there is a large population of items, such as product warranties, the provision is measured at its expected value. Expected value considers all possible outcomes weighted based on their probabilities.

Illustrative example:

Consider the following range of possible outcomes and their respective probability:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Possible outcomes** | $110 | $130 | $160 | $170 | $190 |
| **Probability** | 10% | 15% | 20% | 25% | 30% |

A provision amounting to $162 should be recognized as follows: ($110x10%) + ($130x15%) + ($160x20%) + ($170x25%) + ($190x30%).

10.4.4 Discounting

**Discounting is required where the effect of the time value of money is material.** The discount rate should be a pre‑tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. If this situation occurs, Corporate Finance should be notified to discuss the appropriate accounting.

10.4.5 Re-measurement

Provisions should be re-measured at each balance sheet date based on the best estimate of the settlement amount.

10.4.6 Future events

Future events should be taken into account in measuring a provision if there is sufficient objective evidence that they will occur. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain of being enacted. However, in practice for most cases sufficient objective evidence will not exist until the new legislation is enacted.

10.4.7 Gains

Gains from the expected disposal of assets should not be recognized when measuring a provision.

Therefore, if a provision is recognized for a restructuring, gains on the related sale of any assets should not be considered in measuring the provision. As a result, restructuring costs are likely to be recognized earlier than the gain on the related sale of assets.

10.4.8 Reimbursements

Reimbursements (such as insurance recoveries, indemnities or warranties) are recognized as a separate asset when recovery is virtually certain. The amounts recognized should be limited to the amount of the related provision.

Illustrative example:

One of the Group’s customers has won a claim against the company for $30,000 in respect of defective inventory. The Group can recover the cost of the defect and a penalty of 12 percent from the supplier. The supplier has confirmed that it will pay $33,600 ($30,000 + 12% x $30,000) to the Group as soon as the client is paid.

The Group should recognize a provision for the claim of $30,000. Since the reimbursement is virtually certain it should be recognized as a separate asset. However, the amount recognized should not exceed the amount of the provision recognized for the claim (i.e., $30,000). The expense and the reimbursement may be netted in the income statement; however, the asset and the provision cannot be netted in the balance sheet and must be disclosed separately.

The Group should disclose the unrecognized reimbursement of $3,600 as a contingent asset in the financial statements.

If the amount of a reimbursement cannot be determined, or the party that will make the reimbursement cannot be identified, the reimbursement generally is not virtually certain.

10.4.9 Change in use of provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect management’s best estimate. Only expenditures related to the original nature of the provision can be set against it. If subsequent to initial recognition management determines that it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision is reversed.

10.5 Specific Guidance

10.5.1 Provision for restructuring

A restructuring is a program planned and controlled by management that materially changes the scope of the business or the manner in which it is conducted. The definition of restructuring may include: the closure of business locations in a country or region or the relocation of business activities from one country or region to another, changes in management structure (e.g. elimination of a layer of management) or fundamental reorganizations that have a material effect on the nature and focus of the Group’s operations.

A restructuring provision should only be recognized if the Group has a constructive obligation to implement restructuring measures. A constructive obligation for a restructuring arises only when:

* there is a formal plan for the restructuring specifying:
* the business or part of a business concerned;
* the principal location affected;
* the location, function and approximate number of employees whose services will be terminated;
* the expenditure to be incurred;
* when the plan will be implemented; and
* the Group has raised a valid expectation in those affected that it will carry out the plan by either:
  + starting to implement the plan; and
  + announcing its main features to those affected by it.
  + If one of these criteria (either of the above) is not met there is no constructive obligation and the company cannot make a provision for restructuring.

Restructuring provisions include only incremental costs associated directly with the restructuring.

Examples of costs that should be included in measuring the provision include employee termination benefits relating directly to the restructuring, contract termination costs (such as lease termination penalties) and onerous contract provisions, directly related consulting fees, and expected costs from when operations cease until final disposal.

Restructuring provisions exclude costs associated with ongoing activities. Hence, restructuring provisions should not be recognized for:

* expected future operating costs or expected operating losses (unless they relate to an onerous contract);
* gains or losses on expected disposals or impairments of assets;
* investment in new systems;
* lower utilization of a facility;
* costs of training or relocating staff;
* staff costs for staff that continue to be employed in ongoing operations;
* loyalty bonuses or amounts paid to staff as an incentive to stay;
* costs of moving assets or operations;
* administration or marketing costs;
* allocations of corporate overheads; or

costs of changing the name of an entity.

The most common restructurings for the Group relate to employee terminations and abandonment of leased facilities. If the exit activities are other than involuntary terminations or abandonment of leases facilities, or if the two activities are components of a larger activity (ex. included as part of a plant closure), Corporate Finance should be notified immediately. Also any material changes in the provision should be brought to the attention of management.

In many countries outside of the United States, the authorization of governments or regulatory bodies may be required prior to the implementation of a restructuring or exit plan. In some cases, appropriate notification and discussions may have to be executed and approved by unions and workers councils. As a result, in such cases, management does not have the authority to commit to restructuring plans without all appropriate approvals. Once approvals are obtained, the typical procedures for management approval should be followed and obligations recorded once management, having the authority to do so, commits to a plan.

For employee termination costs, the Group has established a history of either: 1) paying termination benefits based upon a standard formula, or where appropriate, 2) paying termination benefits pursuant to statutory requirements or common law (in Europe or Canada, for example). Estimated employee termination costs include:

* Direct costs (ex. Severance payments)
* Indirect costs (ex. Employer taxes, 401(k), etc.)

Costs already accrued elsewhere (ex. Vacation pay) are not included in the restructuring provision. Also stay or retention bonuses (payments entered into to retain the services of an employee for a specified period of time) would be recognized as an expense ratably over the period the employee provides the service.

10.5.2 Provision for legal claims

As an illustration, provisions for legal claims include:

* Provisions for client disputes;
* Provision for supplier disputes;

Provisions for employee disputes;

Litigation, other claims and contingencies generally represent contingencies that may result in gains or losses to the Group. Management should be made aware of all litigation or threatened litigation regardless of materiality, whether or not it will result in an accrual to the financial statements or if it potentially will result in a gain. Only material claims and other contingencies need to be communicated to Management. These issues can be communicated to Management using the following vehicles:

• Correspondence with the Headquarters Legal Department (primarily if the issue is litigious in nature);

• Correspondence with Corporate Finance.

Any instance in which a lower court or regulatory body has ruled against the Group, an accrual, if estimable, should be recorded; even if it is believed that the ruling will be overturned upon appeal. Only in rare instances will there be no accrual for an adverse judgment and all such instances must be approved by Corporate Finance.

The Group is required to accrue non-asserted claims if the potential claim meets the two criteria above. As with other litigation, claims and contingencies, disclosure of the issue is required, if material.

Any litigation, claim or contingency that occurs after the end of an accounting period but prior to the issuance of the financial statements must also be evaluated to determine if it should be accrued into the prior period or accrued into the current period. Such distinction is based upon whether or not the event giving rise to the claim occurred prior to the date of the financial statements. If the event occurred prior to the date of the financial statements and it meets the criteria for accrual above, the claim should be recorded in the prior period. If the event occurred after the date of the financial statements or did not meet the criteria for accrual, the event is to be disclosed in the notes to the financial statements, if material.

The obligating event for a legal claim is the event that gives rise to the claim, rather than receipt of the claim itself. In cases when the Group disputes a legal claim and legal opinion supports the view that the defense more likely than not will be successful, the legal claim gives rise to a contingent liability (see Contingent assets and liabilities). In these cases no provision is recognized.

If the Group has been unsuccessful in defending a claim, but intends to appeal the decision in a higher court, the provision should be reassessed.

10.5.3 Warranties

Warranty reserves shall be estimated and recorded on a monthly basis representing the obligation that has been incurred related to that month’s sales.

The Group estimates future warranty costs based upon current actual costs incurred and experienced warranty periods. Various products have different stated warranty periods. However, historical experience indicates that few customers request warranty services through the end of the stated warranty period. The Group also maintains a policy of requiring the customer to produce a sales receipt in order to qualify for warranty service. As a result, the Group estimates its warranty period by product based upon historical experience and applies current year actual costs to record a warranty reserve.

10.6 Presentation and disclosure

***Presentation in financial statements:***

Provisions should be classified as *current* in the balance sheet if their settlement will occur within twelve months. Provisions that are not expected to be settled within twelve months should be classified as *non‑current* in the balance sheet (e.g., provision for legal claim where the dispute is not expected to be resolved within the financial year).

***Disclosure***

For each class of provision, the Group 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.

The Group 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, the Company 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 recognized for that expected reimbursement.

Unless the possibility of any outflow in settlement is remote, the company shall disclose for each class of contingent liability at the end of the reporting period 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.