

## **IPSAS 19—PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS**

### **Acknowledgment**

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 37 (1998), “Provisions, Contingent Liabilities and Contingent Assets” published by the International Accounting Standards Committee (IASC). The International Accounting Standards Board (IASB) and the International Accounting Standards Committee Foundation (IASCF) were established in 2001 to replace the IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 37 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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**IPSAS 19—PROVISIONS, CONTINGENT LIABILITIES  
AND CONTINGENT ASSETS**

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*The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the “Preface to International Public Sector Accounting Standards.” International Public Sector Accounting Standards are not intended to apply to immaterial items.*

## **Objective**

The objective of this Standard is to define provisions, contingent liabilities and contingent assets, identify the circumstances in which provisions should be recognized, how they should be measured and the disclosures that should be made about them. The Standard also requires that certain information be disclosed about contingent liabilities and contingent assets in the notes to the financial statements to enable users to understand their nature, timing and amount.

## **Scope**

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for provisions, contingent liabilities and contingent assets, except:**
  - (a) **Those provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits;**
  - (b) **Those resulting from financial instruments that are carried at fair value;**
  - (c) **Those resulting from executory contracts, other than where the contract is onerous subject to other provisions of this paragraph;**
  - (d) **Those arising in insurance entities from contracts with policyholders;**
  - (e) **Those covered by another International Public Sector Accounting Standard;**
  - (f) **Those arising in relation to income taxes or income tax equivalents; and**
  - (g) **Those arising from employee benefits except employee termination benefits that arise as a result of a restructuring as dealt with in this Standard.**
2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.
4. This Standard applies to financial instruments (including guarantees) that are not carried at fair value.
5. This Standard applies to provisions, contingent liabilities and contingent assets of insurance entities other than those arising from contracts with policyholders.
6. This Standard applies to provisions for restructuring (including discontinuing operations). In some cases, a restructuring may meet the definition of a discontinuing operation. Guidance on disclosing information about discontinuing operations is found in International Accounting Standard (IAS) 35, "Discontinuing Operations."<sup>1</sup>

#### **Social Benefits**

7. For the purposes of this Standard "social benefits" refer to goods, services and other benefits provided in the pursuit of the social policy objectives of a government. These benefits may include:
  - (a) The delivery of health, education, housing, transport and other social services to the community. In many cases, there is no

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<sup>1</sup> The Committee has not yet addressed the issue of discontinuing operations, which is the subject of International Accounting Standard (IAS) 35, "Discontinuing Operations." Consistent with the definition in IAS 35, the term discontinuing operation as used in this Standard refers to a component of an entity:

- (a) That the entity, pursuant to a single plan, is:
  - (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction, by demerger or spin-off of ownership of the component to the entity's owners;
  - (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or
  - (iii) Terminating through abandonment;
- (b) That represents a separate major activity/line of business or geographical area of operations; and
- (c) That can be distinguished operationally and for financial reporting purposes.

requirement for the beneficiaries of these services to pay an amount equivalent to the value of these services; and

- (b) Payment of benefits to families, the aged, the disabled, the unemployed, veterans and others. That is, governments at all levels may provide financial assistance to individuals and groups in the community to access services to meet their particular needs, or to supplement their income.
8. In many cases, obligations to provide social benefits arise as a consequence of a government's commitment to undertake particular activities on an on-going basis over the long term in order to provide particular goods and services to the community. The need for, and nature and supply of, goods and services to meet social policy obligations will often depend on a range of demographic and social conditions and are difficult to predict. These benefits generally fall within the "social protection," "education" and "health" classifications under the International Monetary Fund's Government Finance Statistics framework and often require an actuarial assessment to determine the amount of any liability arising in respect of them.
  9. For a provision or contingency arising from a social benefit to be excluded from the scope of this Standard, the public sector entity providing the benefit will not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of the benefit. This exclusion would encompass those circumstances where a charge is levied in respect of the benefit but there is no direct relationship between the charge and the benefit received. The exclusion of these provisions and contingent liabilities from the scope of this Standard reflects the Committee's view that both the determination of what constitutes the "obligating event" and the measurement of the liability require further consideration before proposed Standards are exposed. For example, the Committee is aware that there are differing views about whether the obligating event occurs when the individual meets the eligibility criteria for the benefit or at some earlier stage. Similarly, there are differing views about whether the amount of any obligation reflects an estimate of the current period's entitlement or the present value of all expected future benefits determined on an actuarial basis.
  10. Where an entity elects to recognize a provision for such obligations, the entity discloses the basis on which the provisions have been recognized and the measurement basis adopted. The entity also makes other disclosures required by this Standard in respect of those provisions. IPSAS 1, "Presentation of Financial Statements," provides guidance on dealing with matters not specifically dealt with by another IPSAS. IPSAS 1 also

includes requirements relating to the selection and disclosure of accounting policies.

11. In some cases, social benefits may give rise to a liability for which there is:
  - (a) Little or no uncertainty as to amount; and
  - (b) The timing of the obligation is not uncertain.

Accordingly, these are not likely to meet the definition of a provision in this Standard. Where such liabilities for social benefits exist, they are recognized where they satisfy the criteria for recognition as liabilities (refer also to paragraph 19). An example would be a period-end accrual for an amount owing to the existing beneficiaries in respect of aged or disability pensions that have been approved for payment consistent with the provisions of a contract or legislation.

#### **Other Exclusions from the Scope of the Standard**

12. This Standard does not apply to executory contracts unless they are onerous. Contracts to provide social benefits entered into with the expectation that the entity will not receive consideration that is approximately equal to the value of goods and services provided directly in return from the recipients of those benefits are excluded from the scope of this Standard.
13. Where another International Public Sector Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, certain types of provisions are also addressed in Standards on:
  - (a) Construction contracts (see IPSAS 11, “Construction Contracts”) and
  - (b) Leases (see IPSAS 13, “Leases”). However, as IPSAS 13 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases.
14. This Standard does not apply to provisions for income taxes or income tax equivalents (guidance on accounting for income taxes is found in IAS 12, “Income Taxes”). Nor does it apply to provisions arising from employee benefits (guidance on accounting for employee benefits is found in IAS 19, “Employee Benefits”).
15. Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. IPSAS 9, “Revenue from Exchange Transactions,” identifies the circumstances in

which revenue from exchange transactions is recognized and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of IPSAS 9.

16. This Standard defines provisions as liabilities of uncertain timing or amount. In some countries the term “provision” is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard.
17. Other International Public Sector Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Standard. Accordingly, this Standard neither prohibits nor requires capitalization of the costs recognized when a provision is made.

## Definitions

18. **The following terms are used in this Standard with the meanings specified:**

**A constructive obligation is an obligation that derives from an entity’s actions where:**

- (a) **By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and**
- (b) **As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.**

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

**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 or service potential will be required to settle the obligation; or**

- (ii) **The amount of the obligation cannot be measured with sufficient reliability.**

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

A **legal obligation** is an obligation that derives from:

- (a) A contract (through its explicit or implicit terms);
- (b) Legislation; or
- (c) Other operation of law.

**Liabilities** are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

An **obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

An **onerous contract** is a contract for the exchange of assets or services in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits or service potential expected to be received under it.

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

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

- (a) The scope of an entity's activities; or
- (b) The manner in which those activities are carried out.

#### **Provisions and Other Liabilities**

- 19. Provisions can be distinguished from other liabilities such as payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. By contrast:
  - (a) Payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier (and include payments in respect of social benefits where formal agreements for specified amounts exist); and
  - (b) Accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay). Although it is

sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Accruals are often reported as part of accounts payable, whereas provisions are reported separately.

### **Relationship between Provisions and Contingent Liabilities**

20. In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term “contingent” is used for liabilities and assets that are not recognized because their 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. In addition, the term “contingent liability” is used for liabilities that do not meet the recognition criteria.
21. This Standard distinguishes between:
  - (a) Provisions—which are recognized as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligations; and
  - (b) Contingent liabilities—which are not recognized as liabilities because they are either:
    - (i) Possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits or service potential; or
    - (ii) Present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

## **Recognition**

### **Provisions**

22. **A provision should be recognized when:**
  - (a) **An entity has a present obligation (legal or constructive) as a result of a past event;**

- (b) **It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and**
- (c) **A reliable estimate can be made of the amount of the obligation.**

**If these conditions are not met, no provision should be recognized.**

#### **Present Obligation**

- 23. **In some cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date.**
- 24. In most cases it will be clear whether a past event has given rise to a present obligation. In other cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such cases, an entity determines whether a present obligation exists at the reporting date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting date. On the basis of such evidence:
  - (a) Where it is more likely than not that a present obligation exists at the reporting date, the entity recognizes a provision (if the recognition criteria are met); and
  - (b) Where it is more likely that no present obligation exists at the reporting date, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote (see paragraph 100).

#### *Past Event*

- 25. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:
  - (a) Where the settlement of the obligation can be enforced by law; or
  - (b) 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 entity will discharge the obligation.
- 26. Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognized for costs that need to be incurred to continue an entity's ongoing activities in the future. The only liabilities recognized in

an entity's statement of financial position are those that exist at the reporting date.

27. It is only those obligations arising from past events existing independently of an entity's future actions (that is, the future conduct of its activities) that are recognized as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage imposed by legislation on a public sector entity. Both of these obligations would lead to an outflow of resources embodying economic benefits or service potential in settlement regardless of the future actions of that public sector entity. Similarly, a public sector entity would recognize a provision for the decommissioning costs of a defense installation or a government-owned nuclear power station to the extent that the public sector entity is obliged to rectify damage already caused IPSAS 17, "Property, Plant and Equipment," deals with items, including dismantling and site restoring costs, that are included in the cost of an asset). In contrast, because of legal requirements, pressure from constituents, or a desire to demonstrate community leadership, an entity may intend or need to carry out expenditure to operate in a particular way in the future. An example would be where a public sector entity decides to fit emission controls on certain of its vehicles or a government laboratory decides to install extraction units to protect employees from the fumes of certain chemicals. Because the entities can avoid the future expenditure by their future actions — for example, by changing their method of operation, they have no present obligation for that future expenditure and no provision is recognized.
28. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed — indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a decision by an entity's management, governing body or controlling entity does not give rise to a constructive obligation at the reporting date unless the decision has been communicated before the reporting date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.
29. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused by a government agency there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the controlling government or the individual agency

publicly accepts responsibility for rectification in a way that creates a constructive obligation.

30. Where details of a proposed new law have yet to be finalized, an obligation arises only when the legislation is virtually certain to be enacted as drafted. For the purpose of this Standard, such an obligation is treated as a legal obligation. However, differences in circumstances surrounding enactment often make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases, it is not possible to judge whether a proposed new law is virtually certain to be enacted as drafted and any decision about the existence of an obligation should await the enactment of the proposed law.

*Probable Outflow of Resources Embodying Economic Benefits or Service Potential*

31. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits or service potential to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, that is, the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote (see paragraph 100).
32. Where there are a number of similar obligations (for example, a government's obligation to compensate individuals who have received contaminated blood from a government-owned hospital) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognized (if the other recognition criteria are met).

*Reliable Estimate of the Obligation*

33. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other assets or liabilities. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision.

34. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognized. That liability is disclosed as a contingent liability (see paragraph 100).

#### **Contingent Liabilities**

35. **An entity should not recognize a contingent liability.**
36. A contingent liability is disclosed, as required by paragraph 100, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote.
37. Where an entity is jointly and severally liable for an obligation the part of the obligation that is expected to be met by other parties is treated as a contingent liability. For example, in the case of joint venture debt, that part of the obligation that is to be met by other joint venture participants is treated as a contingent liability. The entity recognizes a provision for the part of the obligation for which an outflow of resources embodying economic benefits or service potential is probable, except in the rare circumstances where no reliable estimate can be made.
38. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits or service potential has become probable. If it becomes probable that an outflow of future economic benefits or service potential will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made). For example, a local government entity may have breached an environmental law but it remains unclear whether any damage was caused to the environment. Where, subsequently it becomes clear that damage was caused and remediation will be required, the entity would recognize a provision because an outflow of economic benefits is now probable.

#### **Contingent Assets**

39. **An entity should not recognize a contingent asset.**
40. Contingent assets usually arise from unplanned or other unexpected events that are not wholly within the control of the entity and give rise to the possibility of an inflow of economic benefits or service potential to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.
41. Contingent assets are not recognized in financial statements since this may result in the recognition of revenue that may never be realized. However,

when the realization of revenue is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

42. A contingent asset is disclosed, as required by paragraph 105, where an inflow of economic benefits or service potential is probable.
43. Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits or service potential will arise and the asset's value can be measured reliably, the asset and the related revenue are recognized in the financial statements of the period in which the change occurs. If an inflow of economic benefits or service potential has become probable, an entity discloses the contingent asset (see paragraph 105).

## Measurement

### Best Estimate

44. **The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the reporting date.**
45. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the reporting date. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the reporting date.
46. The estimates of outcome and financial effect are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting date.

#### *Example*

A government medical laboratory provides diagnostic ultrasound scanners to both government owned and privately owned medical centers and hospitals on a full cost recovery basis. The equipment is provided with a warranty under which the medical centers and hospitals are covered for the cost of repairs of any defects that become apparent within the first six months after purchase. If minor defects were detected

in all equipment provided, repair costs of 1 million currency units would result. If major defects were detected in all equipment provided, repair costs of 4 million currency units would result. The laboratory's past experience and future expectations indicate that, for the coming year, 75% of the equipment will have no defects, 20% of the equipment will have minor defects and 5% of the equipment will have major defects. In accordance with paragraph 32, the laboratory assesses the probability of an outflow for the warranty obligations as a whole.

The expected value of the cost of repairs is:

$$(75\% \text{ of nil}) + (20\% \text{ of } 1\text{m}) + (5\% \text{ of } 4\text{m}) = 400,000$$

47. Uncertainties surrounding the amount to be recognized as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is "expected value." The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60% or 90%. 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.
48. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where 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. For example, if a government has to rectify a serious fault in a defense vessel that it has constructed for another government, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 100,000 currency units, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.
49. The provision is measured before tax or tax equivalents. Guidance on dealing with the tax consequences of a provision, and changes in it, is found in IAS 12, "Income Taxes."

#### **Risks and Uncertainties**

50. **The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.**

51. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that revenue or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.
52. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 98(b).

#### Present Value

53. **Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.**
54. Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting date are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.
55. When a provision is discounted over a number of years, the present value of the provision will increase each year as the provision comes closer to the expected time of settlement (refer to Appendix E). Paragraph 97(e) of this Standard requires disclosure of the increase during the period in the discounted amount arising from the passage of time.
56. **The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.**
57. In some jurisdictions, income taxes or income tax equivalents are levied on a public sector entity's surplus for the period. Where such income taxes are levied on public sector entities, the discount rate selected should be a pre-tax rate.

#### Future Events

58. **Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.**

59. Expected future events may be particularly important in measuring provisions. For example, certain obligations may be index linked to compensate recipients for the effects of inflation or other specific price changes. If there is sufficient evidence of likely expected rates of inflation this should be reflected in the amount of the provision. Another example of future events affecting the amount of a provision is where a government believes that the cost of cleaning up the tar, ash and other pollutants associated with a gasworks' site at the end of its life will be reduced by future changes in technology. In this case, the amount recognized reflects the cost that technically qualified, objective observers reasonably expect to be incurred, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.
60. The effect of possible new legislation which may affect the amount of an existing obligation of a government or an individual public sector entity is taken into consideration in measuring that obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases, sufficient objective evidence will not exist until the new legislation is enacted.

#### **Expected Disposal of Assets**

61. **Gains from the expected disposal of assets should not be taken into account in measuring a provision.**
62. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognizes gains on expected disposals of assets at the time specified by the International Public Sector Accounting Standard dealing with the assets concerned.

#### **Reimbursements**

63. **Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized when, and only when, it is virtually certain that**

**reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognized for the reimbursement should not exceed the amount of the provision.**

64. **In the statement of financial performance, the expense relating to a provision may be presented net of the amount recognized for a reimbursement.**
65. Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly. For example, a government agency may have legal liability to an individual as a result of misleading advice provided by its employees. However, the agency may be able to recover some of the expenditure from professional indemnity insurance.
66. In most cases, the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognized for the full amount of the liability, and a separate asset for the expected reimbursement is recognized when it is virtually certain that reimbursement will be received if the entity settles the liability.
67. In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case, the entity has no liability for those costs and they are not included in the provision.
68. As noted in paragraph 37, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

### **Changes in Provisions**

69. **Provisions should be reviewed at each reporting date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, the provision should be reversed.**
70. Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognized as an interest expense.

## Use of Provisions

71. **A provision should be used only for expenditures for which the provision was originally recognized.**
72. Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

## Application of the Recognition and Measurement Rules

### Future Operating Net Deficits

73. **Provisions should not be recognized for net deficits from future operating activities.**
74. Net deficits from future operating activities do not meet the definition of liabilities in paragraph 18 and the general recognition criteria set out for provisions in paragraph 22.
75. An expectation of net deficits from future operating activities is an indication that certain assets used in these activities may be impaired. An entity tests these assets for impairment. Guidance on accounting for impairment is found in IAS 36, "Impairment of Assets."

### Onerous Contracts

76. **If an entity has a contract that is onerous, the present obligation (net of recoveries) under the contract should be recognized and measured as a provision.**
77. Paragraph 76 of this Standard applies only to contracts that are onerous. Contracts to provide social benefits entered into with the expectation that the entity does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits are excluded from the scope of this Standard.
78. Many contracts evidencing exchange transactions (for example, some routine purchase orders) can be canceled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognized. Executory contracts that are not onerous fall outside the scope of this Standard.
79. This Standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits or service potential expected to be received under it

which includes amounts recoverable. Therefore, it is the present obligation net of recoveries that is recognized as a provision under paragraph 76. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

80. Before a separate provision for an onerous contract is established, an entity recognizes any impairment loss that has occurred on assets dedicated to that contract.

### **Restructuring**

81. The following are examples of events that may fall under the definition of restructuring:
- (a) Termination or disposal of an activity or service;
  - (b) The closure of a branch office or termination of activities of a government agency in a specific location or region or the relocation of activities from one region to another;
  - (c) Changes in management structure, for example, eliminating a layer of management or executive service; and
  - (d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.
82. A provision for restructuring costs is recognized only when the general recognition criteria for provisions set out in paragraph 22 are met. Paragraphs 83 to 96 set out how the general recognition criteria apply to restructurings.
83. **A constructive obligation to restructure arises only when an entity:**
- (a) **Has a detailed formal plan for the restructuring identifying at least:**
    - (i) **The activity/operating unit or part of an activity/operating unit 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.**

84. Within the public sector, restructuring may occur at the whole-of-government, portfolio or ministry, or agency level.
85. Evidence that a government or an individual entity has started to implement a restructuring plan would be provided, for example, by the public announcement of the main features of the plan, the sale or transfer of assets, notification of intention to cancel leases or the establishment of alternative arrangements for clients of services. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (that is, setting out the main features of the plan) that it gives rise to valid expectations in other parties such as users of the service, suppliers and employees (or their representatives) that the government or the entity will carry out the restructuring.
86. For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the government or individual entity is at present committed to restructuring, because the timeframe allows opportunities for the government or entity to change its plans.
87. A decision by management or the governing body to restructure taken before the reporting date does not give rise to a constructive obligation at the reporting date unless the entity has, before the reporting date:
- (a) Started to implement the restructuring plan; or
  - (b) Announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

In some cases, an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting date. Disclosure may be required under IPSAS 14, “Events After the Reporting Date,” if the restructuring is of such importance that its non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.

88. Although a constructive obligation is not created solely by a management or governing body decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale or transfer of an operation, may have been concluded subject only to governing body or board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of paragraph 83 are met.
89. In some countries, the ultimate authority for making decisions about a public sector entity is vested in a governing body or board whose membership includes representatives of interests other than those of management (for example, employees) or notification to these representatives may be necessary before the governing body or board decision is taken. Because a decision by such a governing body or board involves communication to these representatives, it may result in a constructive obligation to restructure.

*Sale or Transfer of Operations*

90. **No obligation arises as a consequence of the sale or transfer of an operation until the entity is committed to the sale or transfer, that is, there is a binding agreement.**
91. Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.
92. Restructuring within the public sector often involves the transfer of operations from one controlled entity to another and may involve the transfer of operations at no or nominal consideration. Such transfers will often take place under a government directive and will not involve binding agreements as described in paragraph 90. An obligation exists only when there is a binding transfer agreement. Even where proposed transfers do not lead to the recognition of a provision, the planned transaction may require disclosure under other International Public Sector Accounting Standards or proposed Standards such as the IPSAS 14, “Events After the Reporting Date” and IPSAS 20, “Related Party Disclosures.”

*Restructuring Provisions*

93. **A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:**
- (a) **Necessarily entailed by the restructuring; and**
  - (b) **Not associated with the ongoing activities of the entity.**
94. A restructuring provision does not include such costs as:
- (a) Retraining or relocating continuing staff;
  - (b) Marketing; or
  - (c) Investment in new systems and distribution networks.
- These expenditures relate to the future conduct of an activity and are not liabilities for restructuring at the reporting date. Such expenditures are recognized on the same basis as if they arose independently of a restructuring.
95. Identifiable future operating net deficits up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract as defined in paragraph 18.
96. As required by paragraph 61, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

**Disclosure**

97. **For each class of provision, an entity should 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 (that is, 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.**

98. **An entity should 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 or service potential;**
  - (b) **An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events, as addressed in paragraph 58; and**
  - (c) **The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.**
99. **Where an entity elects to recognize in its financial statements provisions for social benefits for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits, it should make the disclosures required in paragraphs 97 and 98 in respect of those provisions.**
100. **Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the reporting date a brief description of the nature of the contingent liability and, where practicable:**
- (a) **An estimate of its financial effect, measured under paragraphs 44 to 62;**
  - (b) **An indication of the uncertainties relating to the amount or timing of any outflow; and**
  - (c) **The possibility of any reimbursement.**
101. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 98(a) and (b) and 100(a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to one type of obligation, but it would not be appropriate to treat as a single class amounts relating to environmental restoration costs and amounts that are subject to legal proceedings.
102. Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by paragraphs 97, 98 and 100 in a way that shows the link between the provision and the contingent liability.

PROVISIONS, CONTINGENT LIABILITIES  
AND CONTINGENT ASSETS

103. An entity may in certain circumstances use external valuation to measure a provision. In such cases, information relating to the valuation can usefully be disclosed.
104. The disclosure requirements in paragraph 100 do not apply to contingent liabilities that arise from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods or services provided, directly in return from the recipients of those benefits (see paragraphs 1(a) and 7–11 for a discussion of the exclusion of social benefits from this Standard).
105. **Where an inflow of economic benefits or service potential is probable, an entity should disclose a brief description of the nature of the contingent assets at the reporting date, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 44 to 62.**
106. The disclosure requirements in paragraph 105 are only intended to apply to those contingent assets where there is a reasonable expectation that benefits will flow to the entity. That is, there is no requirement to disclose this information about all contingent assets (see paragraphs 39 to 43 for a discussion of contingent assets). It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of revenue arising. For example, a contingent asset would arise from a contract where a public sector entity allows a private sector company to mine one of its properties in exchange for a royalty based on a set price per ton extracted and the company has commenced mining. In addition to disclosing the nature of the arrangement, the contingent asset should be quantified where a reasonable estimate can be made of the quantity of mineral to be extracted and the timing of the expected cash inflows. If there were no proven reserves or some other circumstances prevailed that indicated that it would be unlikely that any minerals would be extracted, the public sector entity would not disclose information required by paragraph 105 as there is no probable flow of benefits.
107. The disclosure requirements in paragraph 105 encompass contingent assets from both exchange and non-exchange transactions. Whether a contingent asset exists in relation to taxation revenues rests on the interpretation of what constitutes a “taxable event.” The determination of the taxable event for taxation revenue and its possible implications for the disclosure of contingent assets related to taxation revenues are to be dealt with as a part of a separate project on non-exchange revenue.

108. **Where any of the information required by paragraphs 100 and 105 is not disclosed because it is not practicable to do so, that fact should be stated.**
109. **In extremely rare cases, disclosure of some or all of the information required by paragraphs 97 to 107 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.**

### **Transitional Provisions**

110. **The effect of adopting this Standard on its effective date (or earlier) should be reported as an adjustment to the opening balance of accumulated surpluses/(deficits) for the period in which the Standard is first adopted. Entities are encouraged, but not required, to adjust the opening balance of accumulated surpluses/(deficits) for the earliest period presented and to restate comparative information. If comparative information is not restated, this fact should be disclosed.**
111. The Standard requires a different treatment from IPSAS 3, “Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies.” IPSAS 3 requires comparative information to be restated (benchmark treatment) or additional pro forma comparative information on a restated basis to be disclosed (allowed alternative treatment) unless it is impracticable to do so. This Standard requires that any prior period adjustment resulting from the adoption of this Standard for the first time be made directly against the opening balance of accumulated surpluses/(deficits) (benchmark treatment under IPSAS 3).

### **Effective Date**

112. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2004. Earlier application is encouraged.**
113. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity’s annual financial statements covering periods beginning on or after the date of adoption.

## Appendix A

### Tables—Provisions, Contingent Liabilities, Contingent Assets and Reimbursements

*The purpose of this appendix is to summarize the main requirements of the standards. It does not form part of the standards and should be read in the context of the full text of the standards.*

#### *Provisions and Contingent Liabilities*

<p><b>Where, as a result of past events, there may be an outflow of resources embodying future economic benefits or service potential in settlement of: (a) a present obligation; or (b) a possible obligation 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.</b></p>		
<p><b>There is a present obligation that probably requires an outflow of resources.</b></p>	<p><b>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.</b></p>	<p><b>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</b></p>
<p>A provision is recognized (paragraph 22).</p> <p>Disclosures are required for the provision (paragraphs 97 and 98).</p>	<p>No provision is recognized (paragraph 35).</p> <p>Disclosures are required for the contingent liability (paragraph 100).</p>	<p>No provision is recognized (paragraph 35).</p> <p>No disclosure is required (paragraph 100).</p>

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognized because it cannot be measured reliably. Disclosures are required for the contingent liability.

*Contingent Assets*

**Where, as a result of past events, there is a possible asset 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.**

<b>The inflow of economic benefits or service potential is virtually certain.</b>	<b>The inflow of economic benefits or service potential is probable, but not virtually certain.</b>	<b>The inflow of economic benefits or service potential is not probable.</b>
The asset is not contingent (paragraph 41).	No asset is recognized (paragraph 39).  Disclosures are required (paragraph 105).	No asset is recognized (paragraph 39).  No disclosure is required (paragraph 105).

PROVISIONS, CONTINGENT LIABILITIES  
AND CONTINGENT ASSETS

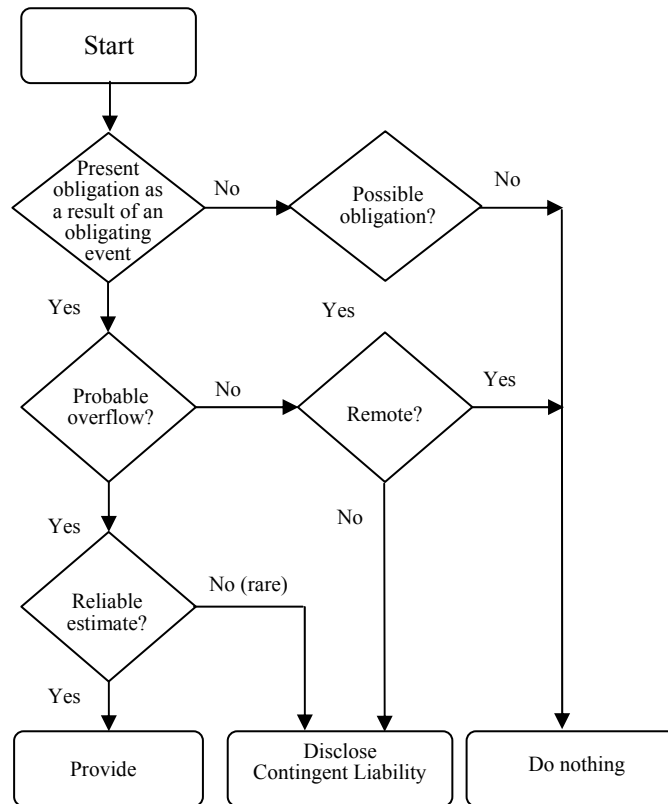
*Reimbursements*

<p><b>Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.</b></p>		
<p><b>The entity has no obligation for the part of the expenditure to be reimbursed by the other party.</b></p>	<p><b>The obligation for the amount expected to be reimbursed remains with the entity and it is virtually certain that reimbursement will be received if the entity settles the provision.</b></p>	<p><b>The obligation for the amount expected to be reimbursed remains with the entity and the reimbursement is not virtually certain if the entity settles the provision.</b></p>
<p>The entity has no liability for the amount to be reimbursed (paragraph 67).</p>	<p>The reimbursement is recognized as a separate asset in the statement of financial position and may be offset against the expense in the statement of financial performance. The amount recognized for the expected reimbursement does not exceed the liability (paragraphs 63 and 64).</p>	<p>The expected reimbursement is not recognized as an asset (paragraph 63).</p>
<p>No disclosure is required.</p>	<p>The reimbursement is disclosed together with the amount recognized for the reimbursement (paragraph 98(c)).</p>	<p>The expected reimbursement is disclosed (paragraph 98(c)).</p>

Appendix B

**Decision Tree**

*The purpose of the decision tree is to summarize the main recognition requirements of the standards for provisions and contingent liabilities that fall within the scope of the Standard. The decision tree does not form part of the standards and should be read in the context of the full text of the standards. Note: in some cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date (paragraph 23 of the Standard).*



## Appendix C

### Examples: Recognition

*This appendix illustrates the application of the standards to assist in clarifying their meaning. It does not form part of the standards.*

*All the entities in the examples have a reporting date of December 31. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets — this aspect is not dealt with in the examples.*

*The cross-references provided in the examples indicate paragraphs of the Standard that are particularly relevant. The appendix should be read in the context of the full text of the standards.*

*References to “best estimate” are to the present value amount, where the effect of the time value of money is material.*

#### *Example 1: Warranties*

Government Department A manufactures search and rescue equipment for use within the Government and for sale to the public. At the time of sale the Department gives warranties to purchasers in relation to certain products. Under the terms of the sale the Department undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (that is, more likely than not) that there will be some claims under the warranties.

#### *ANALYSIS*

**Present obligation as a result of a past obligating event** — The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits or service potential in settlement**—Probable for the warranties as a whole (see paragraph 32).

**Conclusion**—A provision is recognized for the best estimate of the costs of making good under the warranty products sold on or before the reporting date (see paragraphs 22 and 32).

#### *Example 2A: Contaminated Land—Legislation Virtually Certain to be Enacted*

A provincial government owns a warehouse on land near a port. The provincial government has retained ownership of the land because it may require the land for future expansion of its port operations. For the past ten years a group of farmers have leased the property as a storage facility for agricultural chemicals. The national government announces its intention to enact environmental legislation requiring property owners to accept liability for environmental pollution, including the cost of

cleaning-up contaminated land. As a result, the provincial government introduces a hazardous chemical policy and begins applying the policy to its activities and properties. At this stage it becomes apparent that the agricultural chemicals have contaminated the land surrounding the warehouse. The provincial government has no recourse against the farmers or its insurance company for the clean-up costs. At December 31, 2001 it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—The obligating event is the contamination of the land because of the virtual certainty of legislation requiring the clean-up.

**An outflow of resources embodying economic benefits or service potential in settlement**—Probable.

**Conclusion**—A provision is recognized for the best estimate of the costs of the clean-up (see paragraphs 22 and 30).

*Example 2B: Contamination and Constructive Obligation*

A government has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The government has a record of honoring this published policy. There is no environmental legislation in place in the jurisdiction. During the course of a naval exercise a vessel is damaged and leaks a substantial amount of oil. The government agrees to pay for the costs of the immediate clean-up and the ongoing costs of monitoring and assisting marine animals and birds.

*ANALYSIS*

**Present obligation as a result of a past obligating event** — The obligating event is the contamination of the environment, which gives rise to a constructive obligation because the policy and previous conduct of the government has created a valid expectation that the government will clean up the contamination.

**An outflow of resources embodying economic benefits or service potential in settlement**—Probable.

**Conclusion**—A provision is recognized for the best estimate of the costs of the clean-up (see paragraphs 22 and 30).

*Example 3: Gravel Quarry*

A government operates a gravel quarry on land that it leases on a commercial basis from a private sector company. The gravel is used for the construction and maintenance of roads. The agreement with the landowners requires the government to restore the quarry site by removing all buildings, reshaping the land and replacing all topsoil. 60% of the eventual restoration costs relate to the removal of the quarry

buildings and restoration of the site, and 40% arise through the extraction of gravel. At the reporting date, the quarry buildings have been constructed and excavation of the site has begun but no gravel has been extracted.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—The construction of buildings and the excavation of the quarry creates a legal obligation under the terms of the agreement to remove the buildings and restore the site and is thus an obligating event. At the reporting date, however, there is no obligation to rectify the damage that will be caused by extraction of the gravel.

**An outflow of resources embodying economic benefits or service potential in settlement**—Probable.

**Conclusion**—A provision is recognized for the best estimate of 60% of the eventual costs that relate to the removal of the buildings and restoration of the site (see paragraph 22). These costs are included as part of the cost of the quarry. The 40% of costs that arise through the extraction of gravel are recognized as a liability progressively when the gravel is extracted.

*Example 4: Refunds Policy*

A government stores agency operates as a centralized purchasing agency and allows the public to purchase surplus supplies. It has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—The obligating event is the sale of the supplies, which gives rise to a constructive obligation because the conduct of the agency has created a valid expectation on the part of its customers that the agency will refund purchases.

**An outflow of resources embodying economic benefits or service potential in settlement**—Probable that a proportion of goods are returned for refund (see paragraph 32).

**Conclusion**—A provision is recognized for the best estimate of the costs of refunds (see paragraphs 18 (the definition of a constructive obligation), 22, 25 and 32).

*Example 5A: Closure of a Division—No Implementation before Reporting Date*

On 12 December 2004 a government decides to close down a division of a government agency. The decision was not communicated to any of those affected before the reporting date (December 31, 2004) and no other steps were taken to implement the decision.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—There has been no obligating event and so there is no obligation.

**Conclusion**—No provision is recognized (see paragraphs 22 and 83).

*Example 5B: Outsourcing of a Division—Implementation Before the Reporting Date*

On December 12, 2004, a government decided to outsource a division of a government department. On December 20, 2004 a detailed plan for outsourcing the division was agreed by the government, and redundancy notices were sent to the staff of the division.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—The obligating event is the communication of the decision to employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be outsourced.

**An outflow of resources embodying economic benefits or service potential in settlement**—Probable.

**Conclusion**—A provision is recognized at December 31, 2004 for the best estimate of the costs of outsourcing the division (see paragraphs 22 and 83).

*Example 6: Legal Requirement to Fit Air Filters*

Under new legislation, a local government entity is required to fit new air filters to its public buildings by 30 June 2005. The entity has not fitted the air filters.

*ANALYSIS*

(a) At the reporting date of December 31, 2004

**Present obligation as a result of a past obligating event**—There is no obligation because there is no obligating event either for the costs of fitting air filters or for fines under the legislation.

**Conclusion**—No provision is recognized for the cost of fitting the filters (see paragraphs 22 and 25–27).

(b) At the reporting date of December 31, 2005

**Present obligation as a result of a past obligating event**—There is still no obligation for the costs of fitting air filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliance of the public buildings).

**An outflow of resources embodying economic benefits or service potential in settlement**—Assessment of probability of incurring fines and penalties for non-

compliance depends on the details of the legislation and the stringency of the enforcement regime.

**Conclusion**—No provision is recognized for the costs of fitting air filters. However, a provision is recognized for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 22 and 25–27).

*Example 7: Staff Retraining as a Result of Changes in the Income Tax System*

The government introduces a number of changes to the income tax system. As a result of these changes, the taxation department (reporting entity) will need to retrain a large proportion of its administrative and compliance staff in order to ensure continued compliance with financial services regulation. At the reporting date, no retraining of staff has taken place.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—There is no obligation because no obligating event (retraining) has taken place.

**Conclusion**—No provision is recognized (see paragraphs 22 and 25–27).

*Example 8: An Onerous Contract*

A hospital laundry operates from a building that the hospital (the reporting entity) has leased under an operating lease. During December 2004 the laundry relocates to a new building. The lease on the old building continues for the next four years: it cannot be canceled. The hospital has no alternative use for the building and the building cannot be re-let to another user.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—The obligating event is the signing of the lease contract, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits or service potential in settlement**—When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the hospital accounts for the lease under IPSAS 13, “Leases”).

**Conclusion**—A provision is recognized for the best estimate of the unavoidable lease payments (see paragraphs 13(b), 22 and 76).

*Example 9: A Single Guarantee*

During 2004, a provincial government gives a guarantee of certain borrowings of a private sector operator providing public services for a fee, whose financial condition at that time is sound. During 2005, the financial condition of the operator deteriorates and at June 30, 2005 the operator files for protection from its creditors.

*ANALYSIS*

(a) At December 31, 2004

**Present obligation as a result of a past obligating event**—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits or service potential in settlement**—No outflow of benefits is probable at December 31, 2004.

**Conclusion**—No provision is recognized (see paragraphs 22 and 31). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraphs 100 and 109).

(b) At December 31, 2005

**Present obligation as a result of a past obligating event**—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits or service potential in settlement**—At December 31, 2005, it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.

**Conclusion**—A provision is recognized for the best estimate of the obligation (see paragraphs 22, 31 and 109).

Note: This example deals with a single guarantee. If an entity has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefits or service potential is probable (see paragraph 32). Where an entity gives guarantees in exchange for a fee, revenue is recognized under IPSAS 9, “Revenue from Exchange Transactions.”

*Example 10: A Court Case*

After a luncheon in 2004, ten people died, possibly as a result of food poisoning from products sold by a restaurant at a public museum (the reporting entity). Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of authorization of the financial statements for the year to 31 December 2004 for issue, the entity’s lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to December 31, 2005, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable.

*ANALYSIS*

(a) At December 31, 2004

**Present obligation as a result of a past obligating event**—On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

**Conclusion**—No provision is recognized by the museum (see paragraphs 23 and 24). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraphs 100 and 109).

(b) At December 31, 2005

**Present obligation as a result of a past obligating event**—On the basis of the evidence available, there is a present obligation.

**An outflow of resources embodying economic benefits or service potential in settlement**—Probable.

**Conclusion**—A provision is recognized for the best estimate of the amount to settle the obligation (paragraphs 22–24 and 109).

*Example 11: Repairs and Maintenance*

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. IPSAS 17, “Property, Plant and Equipment,” gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

*Example 11A: Refurbishment Costs – No Legislative Requirement*

A furnace for heating a building that is leased out by a government department to a number of public sector tenants has a lining that needs to be replaced every five years for technical reasons. At the reporting date, the lining has been in use for three years.

*ANALYSIS*

**Present obligation as a result of a past obligating event**—There is no present obligation.

**Conclusion**—No provision is recognized (see paragraphs 22 and 25–27).

The cost of replacing the lining is not recognized because, at the reporting date, no obligation to replace the lining exists independently of the entity’s future actions — even the intention to incur the expenditure depends on the entity deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognized, the depreciation of the lining takes account of its consumption, that is, it is depreciated over five years. The re-lining costs then incurred are capitalized with the consumption of each new lining shown by depreciation over the subsequent five years.

*Example 11B: Refurbishment Costs—Legislative Requirement*

A government cartography service is required by law to overhaul its aircraft used for aerial mapping once every three years.

*ANALYSIS*

Present obligation as a result of a past obligating event—There is no present obligation.

Conclusion—No provision is recognized (see paragraphs 22 and 25–27).

The costs of overhauling aircraft are not recognized as a provision for the same reasons as the cost of replacing the lining is not recognized as a provision in Example 11A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions — the entity could avoid the future expenditure by its future actions, for example by selling the aircraft.

## Appendix D

### Examples: Disclosures

*The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.*

*Two examples of the disclosures required by paragraph 98 are provided below and on the following page.*

#### **Example 1: Warranties**

A government department with responsibility for the prevention of workplace accidents gives warranties at the time of sale to purchasers of its safety products. Under the terms of the warranty, the department undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the reporting date, a provision of 60,000 currency units has been recognized. The provision has not been discounted as the effect of discounting is not material. The following information is disclosed:

*A provision of 60,000 currency units has been recognized for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the reporting date.*

**Example 2: Decommissioning Costs**

In 2005, a state-owned research facility, which uses a nuclear reactor to develop radio isotopes that are used for medical purposes, recognizes a provision for decommissioning costs of 300 million currency units. The provision is estimated using the assumption that decommissioning will take place in 60–70 years' time. However, there is a possibility that it will not take place until 100–110 years' time, in which case the present value of the costs will be significantly reduced. The following information is disclosed:

*A provision of 300 million currency units has been recognized for decommissioning costs. These costs are expected to be incurred between 2065 and 2075; however, there is a possibility that decommissioning will not take place until 2105–2115. If the costs were measured based upon the expectation that they would not be incurred until 2105–2115 the provision would be reduced to 136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2%.*

*An example is given below of the disclosures required by paragraph 109 where some of the information required is not given because it can be expected to prejudice seriously the position of the entity.*

**Example 3: Disclosure Exemption**

A government research agency is involved in a dispute with a company, which is alleging that the research agency has infringed copyright in its use of genetic material and is seeking damages of 100 million currency units. The research agency recognizes a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 97 and 98 of the Standard. The following information is disclosed:

*Litigation is in process against the agency relating to a dispute with a company that alleges that the agency has infringed patents and is seeking damages of 100 million currency units. The information usually required by IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets," is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The board is of the opinion that the claim can be successfully defended by the agency.*

### **Example: Present Value of a Provision**

*The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.*

*The following example illustrates the journal entries made on initial recognition of the present value of a provision and the subsequent recognition of increases in the present value of that provision. The increase in the provision is recognized as an interest expense (paragraph 70).*

The expected value of a provision at the end of year 5 is 2000 currency units. This expected value has not been risk adjusted. An appropriate discount rate which takes account of the risk associated with this cash flow has been estimated at 12%.

PROVISIONS, CONTINGENT LIABILITIES  
AND CONTINGENT ASSETS

Journal entries to record the provision and changes in the value of the provision each year are as follows:

End of current reporting period

DR	Expense	1134.85	
CR	Provision		1134.85

End of Year 1

DR	Interest Expense	136.18	
CR	Provision		136.18

End of Year 2

DR	Interest Expense	152.52	
CR	Provision		152.52

End of Year 3

DR	Interest Expense	170.83	
CR	Provision		170.83

End of Year 4

DR	Interest Expense	191.33	
CR	Provision		191.33

End of Year 5

DR	Interest Expense	214.29	
CR	Provision		214.29

Calculations:		Increase
Current time:	Present value = $2000/(1.12)^5 = 1134.85$	
End of Year 1:	Present value = $2000/(1.12)^4 = 1271.04$	136.18
End of Year 2:	Present value = $2000/(1.12)^3 = 1423.56$	152.52
End of Year 3:	Present value = $2000/(1.12)^2 = 1594.39$	170.83
End of Year 4:	Present value = $2000/(1.12)^1 = 1785.71$	191.33
End of Year 5:	Present value = $2000/(1.12)^0 = 2000.00$	214.29

### Comparison with IAS 37

International Public Sector Accounting Standard (IPSAS) 19, “Provisions, Contingent Liabilities and Contingent Assets” is drawn primarily from International Accounting Standard (IAS) 37, “Provisions, Contingent Liabilities and Contingent Assets” (1998). The main differences between IPSAS 19 and IAS 37 are as follows:

- IPSAS 19 includes commentary additional to that in IAS 37 to clarify the applicability of the standards to accounting by public sector entities. In particular, the scope of IPSAS 19 clarifies that it does not apply to provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of the goods and services provided directly in return from recipients of those benefits. However, if the entity elects to recognize provisions for social benefits, IPSAS 19 requires certain disclosures in this respect.
- Black letter in IAS 37 has been modified and commentary additional to that in IAS 37 has been included in IPSAS 19 to clarify that, in the case of onerous contracts, it is the present obligation net of recoveries that is recognized as a provision.
- The scope paragraph in IPSAS 19 makes it clear that while provisions, contingent liabilities and contingent assets arising from employee benefits are excluded from the scope of the Standard, the Standard, however, applies to provisions, contingent liabilities and contingent assets arising from termination benefits that result from a restructuring dealt with in the Standard.
- IPSAS 19 uses different terminology, in certain instances, from IAS 37. The most significant examples are the use of the terms “entity,” “revenue,” “statement of financial performance,” and “statement of financial position” in IPSAS 19. The equivalent terms in IAS 37 are “enterprise,” “income,” “income statement,” and “balance sheet.”
- IPSAS 19 contains the definitions of technical terms used in IAS 37 and an additional definition for “executory contracts.”
- The Appendix C examples have been amended to be more reflective of the public sector.
- IPSAS 19 contains an additional appendix (Appendix E) which illustrates the journal entries for recognition of the change in the value of a provision over time, due to the impact of the discount factor.