

**Does a present obligation resulting from a past event under HKAS 37 “Provisions, Contingent Liabilities and Contingent Assets” exist?
(Relevant to AAT Examination Paper 7 – Financial Accounting)**

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HKAS 37 “Provisions, Contingent Liabilities and Contingent Assets” sets out conditions that should be satisfied in order for a provision to be recognized. The conditions include:

- The entity has a present obligation resulting from a past event;
- It is probable that an outflow of resources embodying economic benefits would be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

This article focuses on the first condition set out above for the recognition of provision under HKAS 37 and discusses what a present obligation resulting from a past event is.

What is a present obligation resulting from a past event?

As mentioned above, not all obligations require that a provision be recognized. Instead, only present obligations resulting from a past obligating event give rise to a provision.

An obligating event is an event that creates either (1) a legal obligation or (2) a constructive obligation that results in an entity having no realistic alternative to settling that obligation.

(1) A legal obligation is an obligation that derives from either:

- a contract,
- legislation, or
- other operation of law.

A legal obligation that derives from a contract can come either through the explicit or implicit contract terms.

(2) A constructive obligation is an obligation that derives from an entity’s actions where, 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, as a result, the entity has created a valid expectation on that part of those other parties that it will discharge those responsibilities.

Example

Consider the following real-life example:

Company A is a manufacturing company which produces toxic contaminants throughout its manufacturing process. The toxic contaminants have contaminated land and air. Should Company A recognize a provision relating to the costs of clearing the contaminants produced under HKAS 37 “Provisions, Contingent Liabilities and

Contingent Assets”? Assume that it is probable that an outflow of resources embodying economic benefits would be required to settle the obligation, and Company A can make a reliable estimate of the amount of the obligation.

To answer this question, we need to consider whether a legal obligation or a constructive obligation exists.

(1) Does a legal obligation exist?

This depends on whether there is an environmental law requiring Company A to take action to clear up the contaminants produced.

If there is such a law, then the contamination is an past obligating event that creates a legal obligation to Company A. Provided that it is probable that an outflow of resources embodying economic benefits would be required to settle the obligation, and that Company A can make a reliable estimate of the amount of the obligation, Company A should make a provision for the costs to clear up the contaminants produced.

However, if there is no such environmental law, then the contamination does not create a legal obligation.

(2) Does a constructive obligation exist?

Even if there is no relevant environmental law and hence no legal obligation, Company A should still recognize a provision if a constructive obligation exists.

The question of whether a constructive obligation exists depends on whether the company has created a valid expectation on the part of other parties that it will discharge those responsibilities. This valid expectation is a result of the company's past actions. An example of past actions is a widely publicized company policy stating that the company undertakes to clean up all contamination that it causes even though there is no environmental law. This is particularly relevant if the company is a reputable company which has a record of honouring this policy.

If Company A has widely publicized such a policy, the past obligating event of contamination will create a constructive obligation because Company A has created a valid expectation to the public being affected that it will clean up the contamination produced. So, given that it is probable that an outflow of resources embodying economic benefits would be required to settle the obligation, and Company A can make a reliable estimate of the amount of the obligation, Company A should make a provision for the costs to clear up the contaminants produced.

Although no legal obligation arises because there is no related law, there is still a present obligation resulting from a past obligating event because a constructive obligation exists.

However, if there is neither a legal obligation nor a constructive obligation, then the contamination does not create a present obligation. So there is no need for Company A to recognize a provision under HKAS 37 “Provisions, Contingent Liabilities and

Contingent Assets”.

Conclusion

An entity should only recognize a provision when all the three conditions stipulated above are fulfilled. The traditionally used terms “provision for depreciation”, “provision for impairment of assets” and “provision for doubtful debts” do not meet the three conditions set out above and hence should not be recognized as provisions under HKAS 37 “Provisions, Contingent Liabilities and Contingent Assets”.