Hong Kong Financial Reporting Standards: HKAS 37 and HKAS 10 (Part I)

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Introduction

This article explains two Hong Kong Accounting Standards: HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets" and HKAS 10 "Events after the Balance Sheet Date". Students often confuse whether a given situation should be a provision or an event after the balance sheet date. When preparing for their examination, students should study HKAS 37 and HKAS 10 together and learn to appreciate and clearly differentiate between the accounting issues covered by these two standards.

Objectives of HKAS 37

1. To ensure proper recognition, measurement and disclosure for provisions, contingent liabilities and contingent assets.
2. To stipulate rules for the recognition of provision so that a company cannot use the excuse of prudence to create unnecessary provisions.

Provisions

What is a provision?

A provision is a liability but it differs from other liabilities such as creditors and accruals due to uncertainty in its timing and amount. Because of inadequate information and the future development of an event, a company is unable to tell when a provision is to be settled, or the amount that is required for the settlement. This is not the case for creditors and accruals.

The fee for an outstanding legal case can be an example of a provision. Assuming that a company is being sued for breach of contract, it will not know exactly when the case will be settled or the amount that is required for the final settlement.

Accounting treatment of a provision

A provision has to be recognised as a current liability in a company's financial statements.

Criteria for a provision

According to HKAS 37, for an event to be recognised as a provision, three criteria have to be met:

1. An entity has a present obligation (legal or constructive) as a result of a past obligating event;
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
3. A reliable estimate can be made of the amount of the obligation.

Therefore, in determining whether or not a given event is a provision, students must know how to evaluate and assess the event based on the above three criteria.

Example I

ABC Ltd is being sued by a supplier for breach of contract. The amount being claimed is $5m and, according to legal opinion, it is very likely that ABC Ltd will lose the case and be required to pay the claimed amount.

Now, let us use this example to demonstrate the application of the above criteria in assessing whether a provision is required.

Firstly, the past obligating event is the breach of contract. A past obligating event means a past event that gave rise to a present obligation and that the company must settle the obligation through specific actions. The obligation here is a legal obligation since it involves a legal case.

Secondly, the outflow of economic resources is probable because, according to the legal opinion, it is very likely that ABC Ltd will lose the case and need to pay $5m in settlement. An outflow of resources is regarded as probable when the probability that the outflows will occur is higher than the probability that they will not occur. An outflow of resources embodying economic benefits refers to the fact that a company has to sacrifice or give up certain economic resources, such as by the payment of cash.

Thirdly, since the amount of claim involved is $5m, there is no problem regarding a reliable estimate of the amount of the obligation.

Based on the above analysis, we can conclude that there should be a provision and the amount of $5m has to be recognised as a liability in the financial statements.

Constructive obligation

In addition to a legal obligation as illustrated above, a present obligation can also be a constructive obligation. A constructive obligation means an obligating event that has created valid expectations in other parties that a company will discharge its obligation through specific actions. "Valid expectations from other parties" is a key criterion for a constructive obligation.

Example II

Green Ltd describes itself as a socially-responsible company that cares for environmental wellbeing, and it is a strong advocate for corporate practices that demonstrate environmental concern. The company also pledges that it will rectify any environmental damage caused by its activities. Recently, the company's mining activities have accidentally polluted the environment of a Third World country. There is not yet any legislation in that country that requires the polluter to clean up its pollution. It is assumed that the company cannot reasonably estimate the amount of cleaning costs that will be involved.

Despite the absence of environmental laws, it is reasonable that the public will expect Green Ltd to clean up its pollution voluntarily. This expectation is based on the company's published policy and vision and is deemed to be a valid expectation.

In other words, a constructive obligation can be conceived as an obligation that is self-constructed by a company due to its past practices or policies so that it creates a valid expectation from other parties that the company will carry out certain actions to fulfill its obligations.

In this example, the first criterion "present obligation" is met as there is a constructive obligation (albeit not a legal obligation). The second criterion "probable that an outflow of resources embodying economic benefits" is also met as the company pledges that it will ratify environmental damages caused by its activities. Further, as the company is unable to estimate the clean-up costs reliably, the third criterion is not met and a provision is not required.

Contingent Liabilities

What is a contingent liability?

A contingent liability may arise under the condition of an unrecognised present obligation or a possible obligation.

Unrecognised present obligation

Unrecognised present obligation means there is a present obligation but the company cannot recognise the obligation in its financial statement because the given event does not fulfill the second or third criteria mentioned above, or both, for the recognition of a provision. Example II is an unrecognised present obligation. Further examples (Examples III and IV) of unrecognised present obligations are given below.

Example III

Small Ltd has borrowed $10m from Money Bank for 10 years and the guarantee is provided by its holding company, Big Ltd. Small Ltd is operating in a fast-growth industry and has been earning significant profits. Big Ltd has a present obligation because the company has signed a bank letter providing a loan guarantee to Small Ltd. However, the outflow of resources embodying economic benefits is not probable because Small Ltd is financially sound and the company does not foresee any problem in repaying its loan.

As a result, despite there being a present obligation, no provision should be recognised in Big Ltd's financial statements. On the other hand, there should be a disclosure of the guarantee under contingent liabilities in notes to the accounts. This disclosure is required under HKAS 37 unless the probability of an outflow of economic resources is considered to be remote. The probability is not remote here because there is always a possibility that Big Ltd may suffer a financial loss during the guarantee period (i.e. anytime within the coming ten years).

Example IV

XYZ Tobacco Company is being sued for health damages due to plaintiffs' prolonged periods of smoking cigarettes manufactured by the company. The plaintiffs are a group of lung diseases sufferers. According to legal opinion, in view of proven medical research findings, it is very likely that XYZ Tobacco Company will be found liable. Nevertheless, as a class action is involved and there has been no precedent in this area, it is difficult to estimate the amount of damages that will finally be awarded against the plaintiffs.

In this case, there is a legal obligation, and the company will probably need to sacrifice economic resources in order to settle the obligation. However, as the amount of the obligation cannot be reliably estimated, a provision should not to be recognised; according to HKAS 37, this is a contingent liability.

Possible obligation

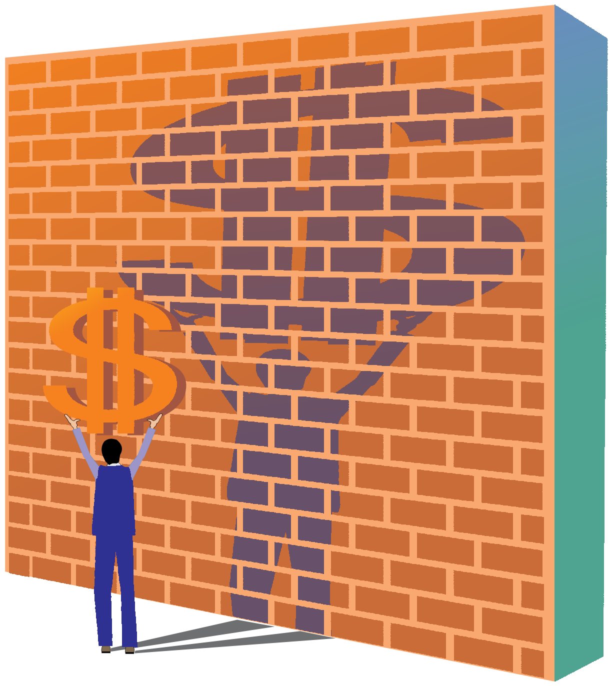
This condition refers to the circumstances under which a certain event has occurred but a present obligation has not yet crystallised. Depending on the development of future events, a present obligation may arise in the future.

Example V

Use the information given in Example I above except that, according to legal opinion, ABC Ltd stands a very good chance of winning the case. Based on this favourable legal opinion, the company does not have a legal obligation. In other words, a present obligation does not exist, but ABC Ltd is said to have a possible obligation because as long as the court case is not yet closed, there is always a possibility that the possible obligation will develop into a present obligation in the future. According to HKAS 37, this event is a contingent liability.

Accounting treatment of contingent liabilities

Contingent liabilities should not be recognised in a company's financial statements but must be disclosed in the notes to the accounts. The company needs to disclose the nature of the event, as well as an estimate of the financial effect that will be involved. If the company is unable to work out the amount of the financial effect reasonably, or it is not practicable for it to disclose the information, it can state this fact.



The following is an illustration of the suggested disclosure of contingent liabilities in Example IV above.

Contingent liability

As at financial year end, XYZ Tobacco Company is being sued by a group of smokers for health damages caused by prolonged periods of smoking cigarettes manufactured by the company. The management is advised by legal counsel that the company does not stand a good chance of defending the case and may need to pay compensation. However, there is no precedent in the country's legal history and the result of the case may also lead to more lawsuits. In view of these circumstances, the management is unable to arrive at a reliable estimate of the ultimate liability that the company may suffer.

Contingent Assets

What is a contingent asset?

A contingent asset arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

A contingent asset is different from an asset. An asset is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. In the case of a contingent asset, an enterprise is unsure whether there will be an ultimate inflow of economic benefits to the entity.

Accounting treatment of contingent assets

A contingent asset should not be recognised in the financial statements as there is always uncertainty with regard to the future inflow of economic benefits to the company or else the company could end up recognising income that will never be realised. On the other hand, any contingent asset should be disclosed in notes to the accounts where an inflow of economic benefits is probable.

Example VI

DEF Ltd is taking legal action against ABC Ltd for breach of contract and the claimed amount is $15m. Legal opinion is that DEF Ltd stands a very good chance of winning the case and should receive compensation from ABC Ltd.

Based on the legal opinion, DEF Ltd can disclose a contingent asset in the notes to its accounts. The details disclosed will include the nature of the event as well as its financial effect. The following is a suggested disclosure:

Contingent asset

As at the financial year end, the company has taken legal action against ABC Ltd for breach of contract and is claiming compensation of $15m. According to solicitors' opinions, the company should stand a good chance of winning the case and should succeed in claiming the full amount of $15m.

This ends the discussion on HKAS 37. In Part II, we will continue our discussion on HKAS 10 "Events after the Balance Sheet Date".

(to be continued in Part II)