IPSAS 19 – Provisions, Contingent Liabilities and Contingent Assets as adopted by the Maltese Government

Guidelines

IPSAS Implementation Team

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Introduction

1. IPSAS 19 - Provisions, Contingent Liabilities and Contingent Assets as adopted by the Maltese Government

1.1 These guidelines refer to the Provisions, Contingent Liabilities and Contingent Assets accounting standard **as adopted by the Maltese Government**. This version is based on the original IPSAS 19 developed by the International Public Sector Accounting Standards Board (IPSASB). Modifications were made to the original standard to make it more applicable to the local context.

2. Scope

2.1 These guidelines were prepared to enable the users to:

2.1.1 Develop a working-level knowledge of the principles contained in the accounting standards; and

2.1.2 Understand the major changes, challenges and benefits resulting from the implementation of IPSAS 19.[1]

3. Target Audience

3.1 These guidelines are designed for finance and non-finance employees employed in Ministries and Departments of the Government of Malta.

4. Guidelines Structure

4.1 These guidelines define provisions, contingent liabilities and contingent assets and identify the circumstances in which provisions should be recognised, how they should be measured, and the disclosures that should be made. It also deals with disclosures on contingent assets and liabilities. This standard does not apply to financial instruments (including guarantees) that are within the scope of IPSAS 29, *Financial Instruments: Recognition and Measurement.*

[1] References to IPSAS 19 and any other IPSAS shall be taken as meaning 'as adopted by the Maltese Government'

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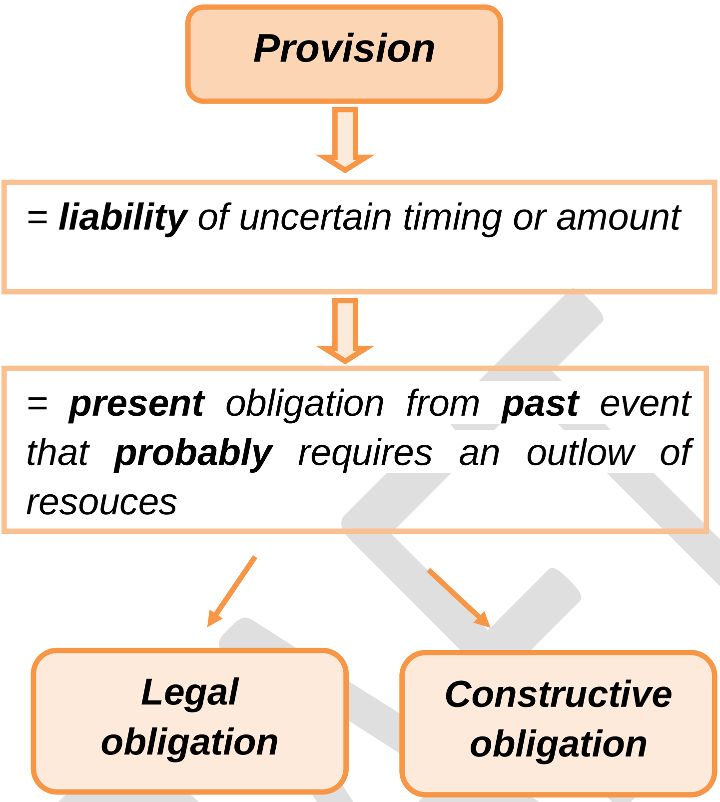
A. Recognition - Provisions

1.



1.1 A Provision is a liability of uncertain timing or amount. Certainty here plays a major part, because if the timing and amount are certain or almost certain, then the liability is considered as a payable or an accrual.

1.2 The following criteria **must** be met for a provision to be **recognised**:

a) there must be a **present obligation** (legal or constructive) as a result of a **past event**;

b) the **outflow of economic** benefits (e.g. Cash payment is probable) **or service potential** to satisfy the obligation must be **probable**; and

c) the amount of economic benefits or service potential required to satisfy the obligation must be **reliably estimated** (e.g the most likely outcome)

IPSAS Team Note

If there is no past event, there is no liability and no provision should be recognised.

2. A **present obligation** meets the definition of an obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. In some cases, a past event is *deemed* to give rise to a present obligation, for example in a lawsuit.

2.1 The entity needs to determine whether a present obligation exists at the reporting date by taking account of all the available evidence, such as the opinion of experts, as at reporting date. The evidence considered includes any additional evidence provided by events after the reporting date. On the basis of such evidence:

2.1.1 A ***provision*** is recognised when the *recognition criteria are met* and where it is *more likely than not* that a present obligation exists;

A ***contingent liability*** is disclosed where it is *more likely that no* present obligation exists at the reporting date, unless the possibility of an outflow of resources embodying economic benefit or service potential is remote.

3. A ***past event*** that leads to a present obligation is called an *obligating event*. 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.

3.1 A ***Legal obligation*** arises from legislation, a contract or other legal act.

3.1.1 Where details of a proposed new law have yet to be finalised, a legal obligation arises only when the legislation is virtually certain to be enacted as drafted.

It could be the case that the proposal of the law is not yet virtually certain, then the obligation should be recognised upon the enactment of the proposed law.

3.2 A ***Constructive obligation*** is an obligation that arises out of conduct and intent rather than a contract and it typically occurs from past conduct. In this case the obligating event creates *valid expectations* in other parties that the entity will discharge its obligations.

3.2.1 This type of obligation may need to be shown on the statement of financial position as a liability if it meets other criteria that require recording as a liability (including the degree of certainty involved and whether the entity has any discretion to avoid the liability).

3.2.2 Changes in the law may give rise to an obligation which at a later date may result in a constructive obligation. For example, although today's environmental damage caused by a government entity does not give rise to an obligation, if the government entity accepts responsibility for rectification, a new obligating event is created.

4. An obligation always involves the commitment to another party, as it follows a decision leading to an outflow of resources embodying economic benefits or service potential. The entity will recognise the event as an obligation, if 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.

5. Examples of circumstances when a provision is recognised:

5.1 Example 1 **Warranties**

A government department produces mechanical equipment for use within government and for sale to the public. This equipment is sold under a warranty, where the department undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. Based on previous experiences, it is probable (more likely than not) that there will be claims during the warranty period.

Is a provision recognised?

Answer:
Present obligation as a result of past event: The obligating event is the sale of mechanical equipment with a warranty, which gives rise to a legal obligation.

Probability of outflow of economic benefit/service potential: Probable for the warranties as a whole.

Conclusion: A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period.

5.2 Example 2 **Land contamination**

The government owns a piece of land near an industrial area. The government had retained ownership due to future projections to expand the industrial zone area. For the past years, a manufacturing company has been renting this land to store chemical products for the use in production. An environmental law has been enacted, whereby the owners have to accept the liability for environmental pollution, including the cost of cleaning up contaminated land.

The government has issued a policy in this regard nationwide. It has become clear that the chemical products retained by the manufacturing company have contaminated the land and its whereabouts. No recourse against the company nor its insurance company can be sought by the government, for clean-up costs.

At year end it is virtually certain that a draft law requiring the clean-up of already contaminated land will be enacted shortly after the year end. Is a provision recognised?

Answer:
Present obligation as a result of past event: The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

Probability of outflow of economic benefit/service potential: Probable given the government cannot seek any recourse against the company nor its insurance.

Conclusion: A provision is recognised for the best estimate of the costs of the clean-up.

5.3 Example 3 **Land contamination**

The government has published an environmental policy in which it undertakes to clean all the contamination that it causes. The government has a record of honouring this 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. Is a provision recognised?

Answer:

Present obligation as a result of past event: The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the government has created a valid expectation on the part of those affected by it that the government will clean up the contamination.

Probability of outflow of economic benefit/service potential: Probable as the government agrees to pay for the costs.

Conclusion: A provision is recognised for the best estimate of the costs of clean-up.

5.4 Example 4 **Guarantees**

During 2015, the government entered into an agreement to guarantee certain borrowings of a private sector operator providing public services at a fee. As at that date, the financial condition of this operator is solid. However, a year later, this operator files for protection from its creditors due to worse financial conditions.

Answer:

<u>In 2015:</u>

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

Probability of outflow of economic benefit/service potential: No outflow of benefits is probable in 2015.

Conclusion: No provision is recognized. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

<u>In 2016:</u>

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

Probability of outflow of economic benefit/service potential: In 2016, 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.

5.5 Example 5 **Court case**

During 2016, a former civil servant started legal proceedings to seek damages from a government entity due to discrimination at the workplace.

As at year end 2016, up till the date when the financial statements were approved, the lawyers advised that most probably the entity will not be found liable. However, during the year ending 2017, the lawyers advised that due to further developments in the case the entity will be found liable and ordered to pay around €50,000 in damages.

Answer:
In 2016:
Present obligation as a result of past event: On the basis of the evidence available as at the end of 2016 - when the financial statements were approved there was no obligation as a result of past events.

In 2017:
Present obligation as a result of past event: The obligating event is the discrimination at the workplace because of the virtual certainty that the government entity will be found liable.

Probability of outflow of economic benefit/service potential: Probable

Conclusion:

In 2016:
No provision is recognised in 2016. The matter is disclosed as contingent liability unless the probability of any outflow is regarded as remote.

In 2017:
A provision is recognised in 2017 for the best estimate of the amount to settle the obligation.

5.6 Example 6 **Refunds**

A government entity operates as a centralised purchasing agency and offers their services also to the general public. It has a policy to refund purchases to dissatisfied customers, even there is no legal obligation to do so. Its policy of making refunds is generally known.

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

Probability of outflow of economic benefit/service potential: Probable, a proportion of goods are returned for refund.

Conclusion: A provision is recognised for the best estimate of the costs of refunds.

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<u>IPSAS Team Note:</u>

The following are not liability **<u>provisions</u>** as **no present financial obligation exists**:

1. **Allowances for doubtful debts and accumulated depreciations**, as these refer to reductions in the value of a relevant asset class;
2. **Commitments**, as these are possible obligations that will be confirmed by the occurrence or non-occurrence of one or more uncertain future events;
3. **Future operating losses**, as an expectation of future operating losses is not a liability but rather an indication that an asset/s may be impaired;
4. **Staff retraining**;
5. **Refurbishment costs** which are done as part of the repairs and maintenance process;
6. **Refurbishment costs** which are incurred as part of a new legislative requirement;
7. **Gains from the expected disposal of an asset**, even if there is a close link between asset disposal and the event giving rise to the provision;
8. **Future costs incurred as part of the ongoing activities**. It is only those obligations arising from past events that are to be recognised, for example, penalties due to unlawful activities.

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B. Contingent Liabilities

1. A **contingent liability** is either;

A **possible obligation** (not present) arising from past events and depending on future events not under the entity's control.	**or**	A present **obligation** from past event not recognised either because - Outflow of economic benefits (payment) is not probable; or - Amount cannot be measured reliably.

2. Contingent liabilities refer to certain obligations which are never recognised as a liability on the financial statements but are disclosed in the Notes to the Financial Statements. If the contingency is **remote,** then disclosure on the financial statements is not required.

3. A contingent liability may arise in case where the entity is held jointly and severally liable for an obligation. The liability is equal to the part of the obligation that is expected to be met by the other parties.

The entity recognises 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.

4. These liabilities are to be **assessed continually** to determine whether an outflow of resources embodying economic benefits or service potential has become probable.

5. 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 recognised in the financial statements for the period in which the change in probability occurs. For example, a government department is in breach of EU legislation, but it remains unclear whether the damages done can be quantified. When it becomes clear that the damages can be quantified and an outflow of resources is now probable, the entity would recognise a provision.

6. **Examples of circumstance when contingent liability may arise**:

Example 1

Following a hazardous waste spill a government department is sued for damages but the government's lawyers advise that the department will probably not be held liable.

Answer: It is <u>not probable</u> that the department will be liable thus no provision will be made, however there is a possible obligation due to a past event (hazardous waste spill) that will only be confirmed by the occurrence or non-occurrence of an uncertain future event (outcome of the court case). Hence the entity has to disclose a ***contingent liability***.

Example 2

Following developments of the case in Example 1 above, the government's lawyers advise that the department will <u>probably</u> be found liable.

Answer: Now that there is a probable liability a **provision** is recognised. The provision will be measured as the best estimate of the amount required to settle the obligation.

C. Difference between a Provision and a Contingent Liability

1. A ***provision*** is a sub class of a ***liability***; because although it represents a present obligation (legal or constructive) with uncertain timing or amount, it **satisfies**:

- **the definition of a liability** i.e. a present obligation as a result of a past event, the settlement of which would result in an outflow of economic benefits; **and**
- **the recognition criteria** i.e. a probable flow of economic benefits that can be reliably measured.

2. A ***contingent liability*** is either:

- a '*possible*' obligation (which means it fails the definition of liability); or
- could be a present obligation (satisfies the definition of a liability) but this present obligation can either be not reliably measured or it can be reliably measured but the outflow of economic benefits may not be probable (fails the recognition criteria).

Thus, if either the definition of liability or recognition criteria are not satisfied, the event is a contingent liability and not a provision.

Liability

- ✓ *a **present** obligation where it is **probable that a future outflow of resources** is required to settle the obligation*
- ✓ *the **amount** of the obligation can be **measured reliably**.*

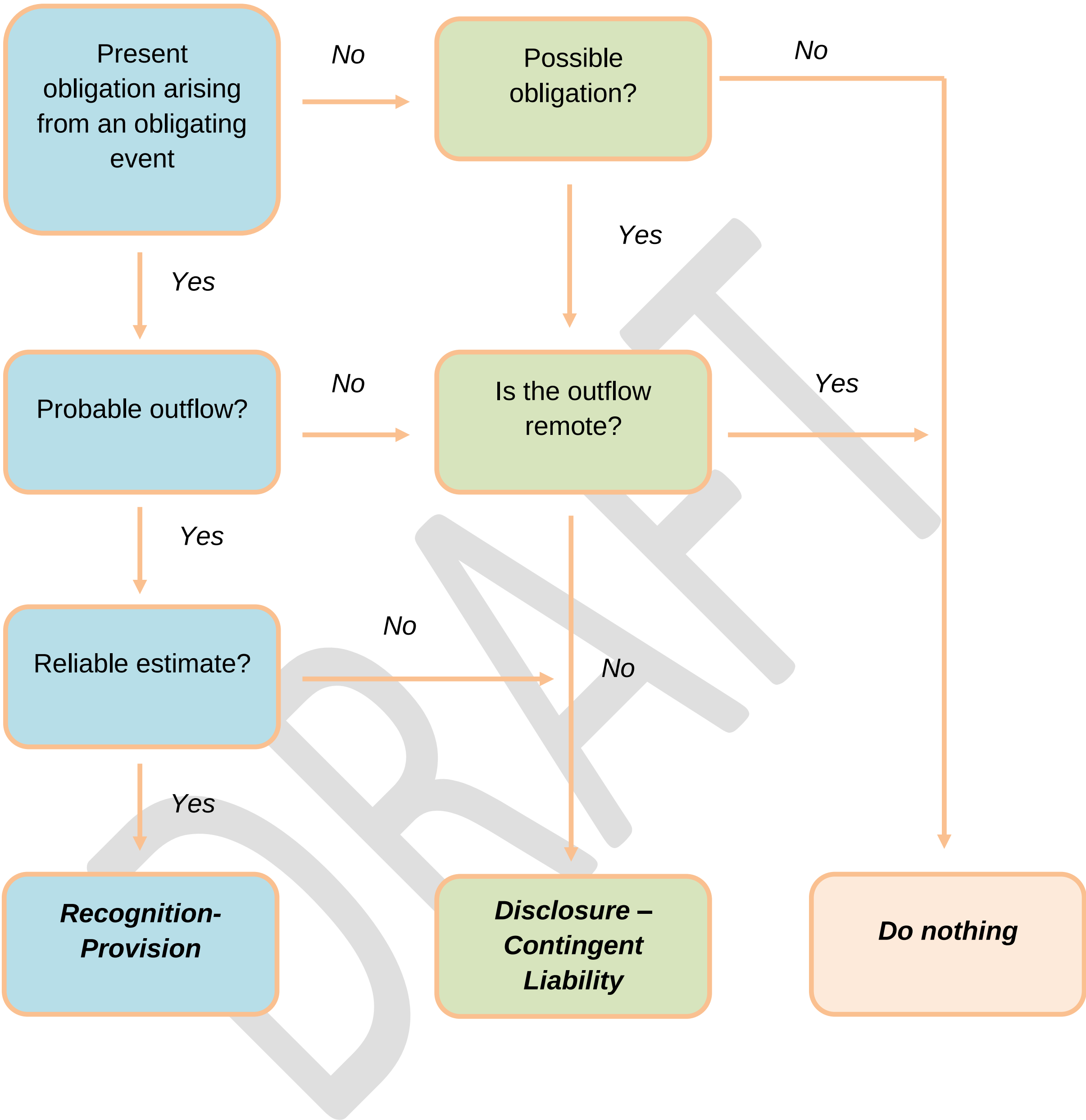
Provision

- ✓ *a **present** obligation that is **uncertain in its timing or amount** but satisfies both the definition and recognition of a liability.*

Contingent Liability

- ✓ *a **possible** obligation (not present) from past event that **will be confirmed** by a future event.*
- ✓ *a **present** obligation from a past event but does not satisfy the recognition criteria of a liability because:*
  - ***Outflow of economic benefits is not probable***
  - ***Amount cannot be reliably measured.***

3. The decision tree for ***recognition of provisions and disclosure of contingent liabilities*** is as below:



IPSAS Team Note

Definition of "probable", "possible" and "remote"

In determining the likelihood of making a payment in the future, "an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e. the probability that the event will occur is greater than the probability that it will not".

In determining a present obligation, it may not be clear if one exists at the reporting date. In this case "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 end of the reporting period".

It therefore follows in all cases that anything less than likely to occur is defined as possible. Where the possibility of future settlement is very small, it should be considered remote.

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D. Contingent Assets

1. A ***contingent asset*** is:
- a ***possible asset*** arising from past events
- that will be **confirmed by some future events** not fully under the entity's control; and
- will give rise to the possibility of **an inflow of economic benefits or service potential** to the entity.

2. These assets are **not to be recognised** but **disclosed** in the notes to the Financial Statements, since this may imply the recognition of revenue that may never be realised. When the realisation of revenue is almost certain then the related asset is not treated as a contingent asset but recognition in the Financial Statements is appropriate.

3. These types of assets are to be continually assessed to ensure that they are properly reflected in the financial statements.

3.1 If it has become virtually certain that the inflow of economic benefits or service potential will arise and its value can be measured reliably; the asset and the related revenue are to be recognised in the financial statements for the period in which the change occurs.

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E. Measurement

1. The amount of a **provision** should be measured at the **best estimate of the expenditure** required to settle the obligation at the end of the reporting period.

1.1 The best estimate of the expenditure required to settle the present obligation; is the amount that would rationally be paid to settle the obligation or to transfer it to a third party.

1.2 In determining a best estimate judgement would be required. The most effective evidence considered include similar transactions, advice from independent experts and any additional evidence provided by events after the reporting date.

1.3 Where ***more than one expenditure outcome is possible***, the most likely outcome may be the best estimate of the liability.

1.4 Alternatively, the obligation can be estimated by weighing all possible outcomes by their associated probabilities, for example in the case of provisions for long service leave.

This method is known as 'expected value' and the amount of the provision will be different depending on whether the probability of a loss of a given amount is, for example, 50% or 80%. In case of multiple range of possible outcomes, and each outcome is equal, the midpoint of the range is used.

1.5 Where a ***single obligation*** is being measured, the individual most likely outcome may be the best estimate of the liability.

1.6 However, an entity may consider other possible outcomes. Where the other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be higher or lower amount.

Example 1 - A government department is held responsible for the damages and faults on school buildings it has built for independent schools.
Originally the value of the repairs amounts to €200,000, but the amount of provision might be higher to make up for the chances of further attempts to rectify the damages and faults.

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1.7 The provision is to be measured before tax or tax equivalents.

2. In reaching the best estimate of a provision, the following need to be considered:

2.1 **Risks and Uncertainties** – Taking into account the risks and uncertainties that inevitably surround many events and circumstances;

2.2 **Present Value -** Discounting provisions where the time value of money is material using a discount rate that reflects the time value of money;

2.3 **Future Events -** Taking future events into account where there is sufficient evidence that they will occur.

3. Risks and Uncertainties

3.1 Risk describes variability of outcome, and a risk adjustment may increase the amount at which a liability is measured. In making judgements under uncertain conditions, the prudence concept (assets and income are not overstated, and liabilities and expenses are not understated) has to be applied, so that revenue or assets are not overstated nor expenses or liabilities are understated.

3.2 In certain circumstances, the degree of uncertainty as to the amount or timing of a provision is so great as to prevent reliable measurement of the provision. The provision is then classified as a contingent liability and it is only disclosed in the notes to the financial statements.

4. Present Value

4.1 Where the time value of money is material, the amount of a provision shall be the **present value** of the expenditures expected to be required to settle the obligation.

4.2 Provisions are to be discounted where the effect is material. For instance, due to the time value of money, provisions relating to the cash outflows that arise soon after the reporting date are more challenging than identical cash flows that arise later.

4.3 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.

4.4 The discount rate/s applied to calculate the present value shall be a pre-tax rate/s that reflect/s the current market assessment of the time value of money and the risks specific to the liability. The discount rate/s shall not reflect risks for which future cash flow estimated have been adjusted. One common practice is the use of Malta Government Stock (MGSs) as a basis for the risk free rate. The risk free rate is normally derived from an MGS with suitable term to maturity and adding any other risks specific to the liability.

4.5 In case that discounting is used, the carrying value of the provision increases in each period to reflect the market value. The increase is then recognised as an interest expense.

Example 2 – The expected value of a recognised provision at the end of year 3 is €2,000. 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%.

Calculations:

Time	**Present Value**	**Increase (Interest)**
Current time	$2000/(1.12)^3$ = 1,423.56	-
End of Year 1	$2000/(1.12)^2$ = 1,594.39	170.83
End of Year 2	$2000/(1.12)^1$ = 1,785.71	191.33
End of Year 3	$2000/(1.12)^0$ = 2,000.00	214.29

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

Debit Expense (SFPE)*	€1.423.56
Credit Provision (SFPO)*	€1,423.56
Being the recognition of a provision for end of current reporting period	

*[SFPE: Statement of Financial Performance
SFPO: Statement of Financial Position]*

Debit Interest Expense (SFPE)	€170.83
Credit Provision (SFPO)	€170.83
Being the recognition of an increase in provision end of year 1	

Debit Interest Expense (SFPE)	€191.33

Credit Provision (SFPO)	€191.33
Being the recognition of an increase in provision end of year 2	

Debit Interest Expense (SFPE)	€214.29
Credit Provision (SFPO)	€214.29
Being the recognition of an increase in provision end of year 3	

5. Future Events

5.1 It is important that future events are taken into account when there is **sufficient objective evidence** that they will occur.

5.2 The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted.

5.3 **Evidence** is required both of (a) what legislation will demand; and of (b) 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.

6. Gains from the **expected disposal of assets** shall not be taken into account in measuring a provision.

7. Reimbursements

7.1 Where a Department is entitled to recover some or all of the expenditure associated with a recognised provision, the **reimbursement** is to be recognised as a separate asset where it is virtually certain that the reimbursement will be received upon settlement of the associated liability.

7.2 The amount recognised for the **reimbursement shall not exceed the amount of the provision.**

7.3 In the income statement, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

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7.4 It may be the case that the department may have a right to receive all or part of the economic benefits required to settle a provision from a third party (for example through an insurance contract, indemnity clauses or supplier's warranty). The other party may either reimburse amounts paid by the department or pay the amounts directly to the creditor. In most situations the department will remain liable for the full provision as it will have to fulfil the obligation if the third party fails to make a repayment.

Example 3 - An individual may sue a government department over wrongful advice given by an employee, and the department may be able to recover expenditure from professional indemnity insurance.

Generally, the department is to remain liable for the whole amount, to make up for full settlement in case that the third party fails to pay the full amount.

In this case, a provision is to be recognised for the full amount of the liability and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received when the department settles the liability.

When the department is not liable to settle the costs if the third party fails to pay, no liability will arise and hence no provision is recognised.

8. Changes in Provisions

8.1 Provisions should be reviewed at each reporting date and adjusted to reflect the current best estimate.

8.2 If it appears that it is no longer probable that an outflow of resources embodying economics will be required to settle the obligation, then the provision should be reversed.

9. Use of Provisions

9.1 The use of provision is to be restricted to the purpose for which it was recognised originally.

9.2 For example, a reserve for plant dismantlement, cannot be used to absorb environmental pollution claims or warranty payments. If an expense is set against a provision that was originally recognised for another purpose, it would hide the impact of the two different events, distorting income performance and possibly constituting financial reporting fraud.

10. Provisions shall not be recognised for **net deficits** from future operating activities.

11. Onerous Contracts

11.1 Present obligations under **onerous contracts** should be recognised and measured as a provision (net of recoveries).

11.2 Onerous contracts are defined as contracts under which the unavoidable costs of satisfying the obligations exceed the economic benefits or service potential expected to be received under it, which includes amounts recoverable.

11.3 Such unavoidable costs in these contracts should be measured at the lower of:

a. The cost of fulfilling the contract; or

b. Any compensation or penalties arising from failure to fulfil the contract.

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

11.5 Executory contracts that are not onerous do not fall within the ambit of these guidelines. That is the expected negative implications of such contracts (executory contracts that are not onerous) cannot be recognised as a provision.

11.6 Contracts to provide social benefits entered 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 these standards.

11.7 Certain contracts in which exchange transactions are involved could be cancelled without paying compensation to the other party, and therefore no obligation exists. In these events, where the contract is treated an onerous, the contract falls within the scope of these guidelines.

11.8 Example 1 **Onerous contract**

A government department has entered into a 4-year purchase contract for the supply of a particular medicinal item. To make the arrangement economically viable for the supplier, the contract provided a guarantee to the supplier that the department would either purchase or pay for a certain quantity of the supplies over the period. The guaranteed amount each year, over 3 years, stood at €200,000 annually.

In the first year, the Department is confident that it will need at least the guaranteed amount, and probably more, therefore there is no requirement to raise a provision.

Before the end of the second year there is a major advancement in the field in which a newly improved formula has been found. The Department foresees that within 6 months (year 3 of the contract) it is more likely than not that it will have access to a better and improved method for fulfilling its requirements and its needs for the current supplies will diminish. As the government department is contractually committed, a provision, equivalent to the supplies not required but guaranteed, will be necessary.

In this example the following is assumed:

	Year 2	Year 3	Year 4
Guaranteed Amount	€ 200,000	€ 200,000	€ 200,000
Agency revised estimated usage	€ 230,000	€110,000	€20,000
Payment under guarantee	Nil	€90,000	€180,000

Answer:

In its financial statements, the government department is required to raise a total provision and associated expense for €270,000 (€90,000 + € 180,000) at the time when it realises that the contract is onerous.

The journal entries at this time are:

Debit Purchase of Goods and Services (SFPE)	€270,000*
Credit Provisions - Other (SFPO)	€270,000
Being the recognition of a provision upon realisation that the contract is onerous.	

*(*note: future liabilities and expenses are not discounted in this example*)

If at any stage the Department revises its usage estimated, the provision should be adjusted accordingly.

Finally the contract and the guarantee are to be paid; the following journal entries would be required:

Debit Provisions - Other (SFPO)	€270,000
Credit Bank (SFPO)	€270,000
Being the pay out of the guarantee at the end of the contract.	

12. Restructuring

12.1 Provisions for **restructuring** costs are recognised only when the general recognition criteria for provisions are met.

12.2 A constructive obligation to restructure arises only when a department;

(a) Has a detailed formal plan for the restructuring which identifies 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 expenditure 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.

Thus, until both the conditions mentioned are satisfied, a restructuring provision cannot be made based upon the concept of constructive obligation.

Although a constructive obligation is not created solely by a management or governing board decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments may have been concluded subject only to governing body or board approval. Once the approval has been obtained and communicated to other parties, the department has a constructive obligation to restructure.

IPSAS Team Note:

Restructuring of an operation: No obligation arises as a consequence of a sale/transfer of an operation. A provision is recognised if there is a binding agreement.

12.3 Only direct expenditures arising from restructuring should be provided for. Such direct expenditures should be;

- necessarily incurred for the restructuring; and
- not associated with the ongoing activities of the entities.

12.4 A provision for restructuring would not include such costs that relate to the future conduct of an activity. These are not liabilities for restructuring at the reporting date and such expenditures are recognised on the same basis as if they arose independently of a restructuring. Such costs may include:

i. costs of retraining or relocating the department's current staff members;
ii. costs of marketing or investments in new systems and distribution networks (such expenditures are considered to be expenses relating to the future conduct of the business of the entity and thus are not liabilities relating to the restructuring program);
iii. identifiable future operating losses up to the date of an actual restructuring (unless they relate to an onerous contract);

iv. any gains on expected disposal of assets in measuring a restructuring provision, even if the sale of the assets is envisaged as part of the restructuring.

12.5 Evidence that a government department has started to implement a restructuring plan would be provided by:

i. the public announcement of the main features of the plan;
ii. the sale or transfer of assets;
iii. notification of intention to cancel leases; or
iv. the establishment of alternative arrangements for clients of services.

12.6 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 it gives rise to valid expectations on other parties, such as users of the service, suppliers and employees that the government department will carry out the restructuring.

12.7 The restructuring plan must be sufficient to give rise to constructive obligation. This implementation plan needs to begin as soon as possible and be completed in a timeframe and significant changes are unlikely to take place.

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 the others that the government department is at present committed to restructuring, because the timeframe allows opportunities for the department to change its plans.

12.8 A constructive obligation may also result from earlier events supplemented by a management or governing body decision and approval. These examples give rise to a constructive obligation:

- termination payments negotiated with employee representatives;
- agreement on the sale or transfer of an operation with the respective purchasers.

12.9 A management decision or a board resolution to restructure taken before the statement of financial position date does not automatically give rise to a constructive obligation at the reporting date unless the department has, before this date, either;

i. started to implement the restructuring plan; or
ii. announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner such that a valid expectation is raised in them (i.e., that the entity will in fact carry out the restructuring and that benefits will be paid to them).

On the other hand, if the department started the implementation of the restructuring plan and announced it, **after the reporting date**, then disclosure is required if the restructuring is material since non-disclosure could influence the economic decisions of users taken on the financial statements.

12.10 The ultimate authority for making decisions about the public service is vested in a governing body or board who are made up of various other stakeholders representing the interests of other than management, such as employees' and private bodies.

Thus, notification to these representatives might be necessary before the governing body makes a decision. Hence, a constructive obligation to restructure, will result since the decision by the governing body involves communication to these stakeholders.

12.11 Examples of events that may fall within the definition of restructuring are:
i. A fundamental reorganization of a department that has a material effect on the nature and focus of its operations;
ii. Drastic changes in the management structure—for example, making all functional units autonomous;
iii. Removing the operation to a more strategic location or place; and
iv. The disposal or termination of an activity or service.

12.12 No obligation arises as a consequence of the sale or transfer of an operation until the department is committed to the sale or transfer, that is, there is a binding agreement.

12.13 Restructuring within the Central Government often involves the transfer of operations from one department to another, and may involve the transfer of operations at no or normal consideration.

Such transfers will often take place under a government directive, and no binding agreements are in place. Thus, in the absence of a binding transfer agreement, no obligation exists and no provision is recognised.

12.14 Example 1 **Restructuring Provision**

Decision has been taken and approval granted for a government entity to reassign and restructure its duties. To this effect this entity had reached negotiations with employees' representatives for an early retirement scheme.

The scheme is applicable for the period between 01/01/2018 and 31/12/2018 and the employees must be 60 years of age as at end of 2018. The amount paid is equivalent to a onetime payment equal to 1-year gross salary (€25,000) plus one-year pension at €700 a month.

If by the end of 2017 the entity received 25 applications from employees what is the provision required? Show the respective journal entries to record this provision.

Answer: A provision of **€ 835,000** is recognised.

25 employees x €25,000 (average annual gross salary) + €700 (monthly pension) x 12 months = **€ 835,000**)

The following journal entry is required on recognition of provision:

Debit Schemes (Early retirement) (SFPE)	€835,000
Credit Provisions - Other (SFPO)	€835,000
Being the recognition of a provision upon realisation of the restructuring scheme.	

When paying out the schemes, the following journal entry would be required:

Debit Provisions - Other (SFPO)	€835,000
Credit Bank (SFPO)	€835,000
Being the pay out of the scheme when realised.	

The above example is based on the fact that all applicants will be paid out.

If this is not the case the provision can be retained until all are paid out and if it is later established that the pending provision balance will not materialise into a payment, then the balance should be subsequently reversed.

F. Summary

1. Provisions and Contingent Liabilities

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.		
There is a present obligation that probably requires an outflow of resources.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognised.	No provision is recognised.	No provision is recognised.
Disclosures are required for the provision.	Disclosures are required for the contingent liability.	No disclosure is required.

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

2. 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.		
The inflow of economic benefits or service potential is virtually certain.	**The inflow of economic benefits or service potential is probable, but not virtually certain.**	**The inflow of economic benefits or service potential is not probable.**
The asset is not contingent.	No asset is recognised.	No asset is recognised.
	Disclosures are required.	No disclosure is required.

3. Reimbursements

Some or all the expenditure required to settle a provision is expected to be reimbursed by another party.		
The entity has no obligation for the part of the expenditure to be reimbursed by the other party.	**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.**	**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.**
The entity has no liability for the amount to be reimbursed.	The reimbursement is recognised 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 recognised for the expected reimbursement does not exceed the liability.	The expected reimbursement is not recognised as an asset.
No disclosure is required.	The reimbursement is disclosed, together with the amount recognised for the reimbursement.	The expected reimbursement is disclosed.

G. Disclosures

1. **For each class of provision, an entity shall disclose:**
   i. The carrying amount at the beginning and end of the period;
   ii. Additional provisions made in the period, including increases to existing provisions;
   iii. Amounts used (that is, incurred and charged against the provision) during the period;
   iv. Unused amounts reversed during the period; and
   v. 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.

2. **The following shall be disclosed for each class of provision:**
   i. A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits or service potential;
   ii. An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
   iii. The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

3. 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 shall make the disclosures as required above.

4. Unless the possibility of any outflow in settlement is remote, an entity shall disclose, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, where practicable:
   i. An estimate of its financial effect;
   ii. An indication of the uncertainties relating to the amount or timing of any outflow; and
   iii. The possibility of any reimbursement.

   4.1 These disclosure requirements 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.

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5. 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. 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.

6. Where a provision and a contingent liability arise from the same set of circumstances, the disclosures requirements as explained above are made in a way that shows the link between the provision and the contingent liability.

7. In certain circumstances it may be necessary to use external valuation to measure a provision. In such cases, information relating to the valuation can usefully be disclosed.

8. Where an inflow of economic benefits or service potential is probable, an entity shall disclose a brief description of the nature of the **contingent assets** at the reporting date, and, where practicable, an estimate of their financial effect.

8.1 These disclosure requirements 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.

8.2 It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of revenue arising.

8.3 These disclosure requirements include contingent assets from both exchange and non-exchange transactions.

8.4 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.

9. Where any of the information required for contingent liabilities and contingent assets is not disclosed because it is not practicable to do so, that fact shall be stated.

10. In extremely rare cases, disclosure of some or all the information required by all of the above paragraphs 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 shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

11. Illustrative disclosure requirements:

Statement of Financial Position as at 31st December 2013 (extract)			
	Notes	2013 (€)	2012 (€)
Liabilities			
Provisions	4	X	X

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Extract from Notes to the Financial Statements

Accounting Policies

1. **Provisions**

Provisions are recognised when the Government has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

Where it is expected that some or all of a provision is to be reimbursed, for example, under an insurance contract, the reimbursement is recognised as a separate asset only when the reimbursement is virtually certain.

The expense relating to any provision is presented in the statement of financial performance net of any reimbursement.

Rehabilitation liability

Rehabilitation costs are provided at the present value of expected costs to settle the obligation using estimated cash flows and are recognised as part of the cost of that particular asset. The cash flows are discounted at a current pre-tax rate that reflects the risks specific to the rehabilitation liability. The unwinding of the discount is expensed as incurred and recognised in the statement of financial performance as a finance cost. The estimated future costs of decommissioning are reviewed annually and adjusted as appropriate. Changes in the estimated future costs or in the discount rate applied are added to or deducted from the cost of the asset.

2. **Contingent liabilities**

Contingent liabilities are not recognised, but details of any contingencies are disclosed in the notes to the financial statements, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote.

3. **Contingent assets**

Contingent assets are not recognised, but details of a possible asset whose existence is contingent on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control are disclosed in the notes to the financial statements.

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

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reliably, the asset and the related revenue are recognised in the financial statements of the period in which the change occurs.

Summary of significant accounting policies

4. **Provisions**

Provisions were raised and management determined an estimate based on the information available.

Provisions are measured at the management's best estimate of the expenditure required to settle the obligation at the reporting date and are discounted to present value where the effect is material.

Assumptions were used in determining the provision for rehabilitation of landfill sites. Landfill areas are rehabilitated over years and the assumption was made that the areas stay the same in size for a number of years.

Provision is made for the estimated cost to be incurred on the long-term environmental obligations, comprising expenditure on pollution control and closure over the estimated life of the landfill. The provision is based on the advice and judgment of qualified engineers.

The estimates are discounted at a pre-tax discount rate that reflect current market assessments of the time value of money.

The increase in the rehabilitation provision due to passage of time is recognised as finance cost in the statement of financial performance.

The cost of ongoing programs to prevent and control pollution and rehabilitate the environment is recognised as an expense when incurred.

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Glossary

"Accruals" 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).

"Accruals-based accounting" Accruals-based accounting is a system of accounting based on the accrual principal, under which revenue is recognised (recorded) when earned, and expenses are recognised when incurred.

"**Constructive obligation**" 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.

"Contingent asset" 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.

"**Contingent liability**" A Contingent Liability is:

(a) A possible obligation that arises from past events, and whose existence will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) A present obligation that arises from past events, but is not recognised 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" Executory contracts are contracts under which neither party has performed any of its obligations, nor both parties have partially performed their obligations to an equal extent.

''International Public Sector Accounting Standards (IPSASs)'' IPSASs are a set of accrual-based accounting standards issued by the IPSAS Board for use by public sector entities around the world in the preparation of financial statements.

"Legal obligation" 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.

"Obligating event" 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.

"**Onerous contract"** 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.

"Payables" 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.

"**Provision**" A Provision is a liability of uncertain timing or amount.

"**Restructuring**" 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.