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The Concept of Accounting for Provisions in Financial Reporting

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What is Accounting Objective?

- **The original task of accounting was to record the past:**
  - Memory replacement
  - Registration of what happened irreversibly
- **Paradigm shift:**
  - Development, integration and globalization of capital markets
  - The emergence of institutional investors
- **Accounting is now trying to predict:**
  - Service to users – to provide decision-making information
  - Reason for criticism - opportunity for subjectivity

Conceptual Framework of US GAAP

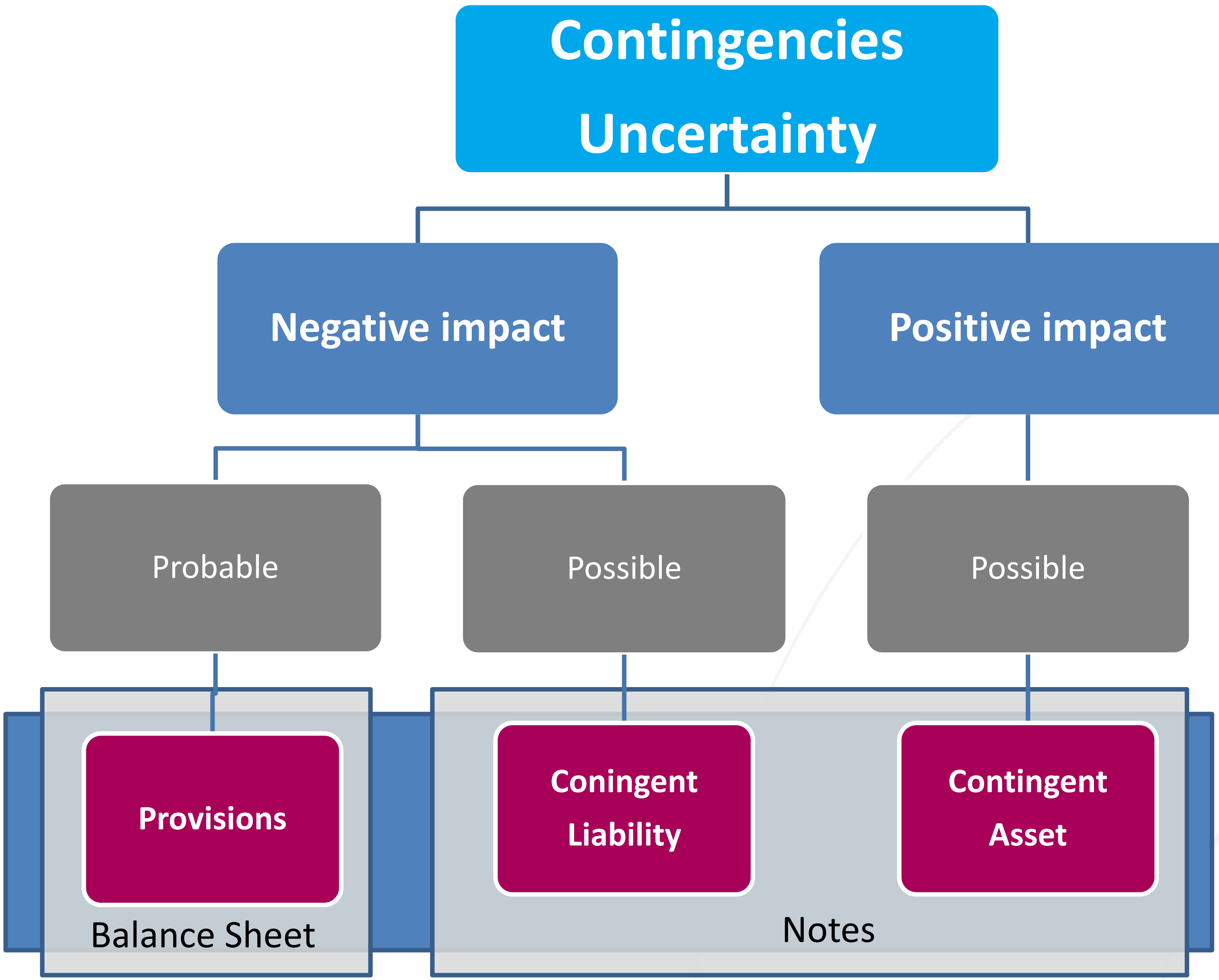
- *„The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions.*
- *To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others **to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows)**."*

Conceptual Framework of IFRS

- *„The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.*
- *Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses.* ***<u>That information can help users to assess the reporting entity's liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.“</u>***

Conceptual Framework of IPSAS

- *„Information about the financial position of a government or other public sector entity will enable users to identify the resources of the entity and claims to those resources at the reporting date. This will provide information useful as input to assessments of such matters as:*
  - *The extent to which management has discharged its responsibilities for safekeeping and managing the resources of the entity;*
  - *The extent to which resources are available to support future service delivery activities, and changes during the reporting period in the amount and composition of those resources and claims to those resources; and*
  - ***The amounts and timing of future cash flows necessary to service and repay existing claims to the entity's resources.“***



IPSAS 19
IAS 37
ACS 450, ACS 460

Definitions in IPSAS 19:

- A **provision** is a liability of uncertain timing or amount.
- **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.
  - A **constructive** obligation
  - A **legal** obligation
- 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.

Legal and Constructive Obligations:

- A **legal obligation** is an obligation that derives from:
  - A contract (through its explicit or implicit terms);
  - Legislation
  - Other operation of law
- 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 the part of those other parties that it will discharge those responsibilities.

Recognition of Provisions:

- **A provision should be recognized when:**
  - An entity 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.
- If these conditions are not met, no provision should be recognized.

Reporting Requirements:

- The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the reporting date.
  - Future events.
  - effect of the time value of money
  - Gains from the expected disposal of assets
- The reimbursement
  - only when, it is virtually certain
  - should be treated as a separate asset.
  - should not exceed the amount of the provision.
- Provisions should be reviewed at each reporting date and adjusted or reversed.
- A provision should be used only for expenditures for which the provision was originally recognized.
- Provisions should not be recognized for net deficits from future operating activities.

Examples:

- Restructuring
- Onerous contract
- Warranties
- Guarantee
- Environmental measures
- Refunds Policy
- Court Case
- Repairs and Maintenance
- Liquidation (Removal), Decommissioning and Restoration

IAS 37, IPSAS 19 and Czech AS (diferencies)

- **IPSAS 19 is based on IAS 37:**
  - there is no conceptual difference between the two standards
  - The text is virtually the same
  - Only some terminology and examples are modified
- **The Czech Act on Accounting and Common Practice is fundamentally different**
  - the definition of provisions in the law is brief and confusing: *„Provisions are intended to cover* ***liabilities or costs*** *that are clearly defined and are either probable or certain that they arise at the balance sheet date, but are not certain of their amount or timing. At the balance sheet date, the provision is the best estimate of the costs that are likely to arise, or, in the case of liabilities, the amount that is required to settle.“*
- **Czech business practice understands provisions mainly as a tax relief under a special law**
- **The Czech public sector is learning to report provisions on the basis of a reform of state accounting**

Public Sector vs. business entities

- **The general provisions of the Act are followed by implementing decrees and Czech Accounting Standards:**
  - For public sector and businesses, different implementing decrees and subsequent accounting standards apply.
  - Regulation for the public sector is more modern compared to the rules for entrepreneurs and partially implements the principles of IPSAS
- **The Czech legislation completely lacks:**
  - taking into account the time value of money
  - the possibility of making a provision as part of the purchasing cost of the asset

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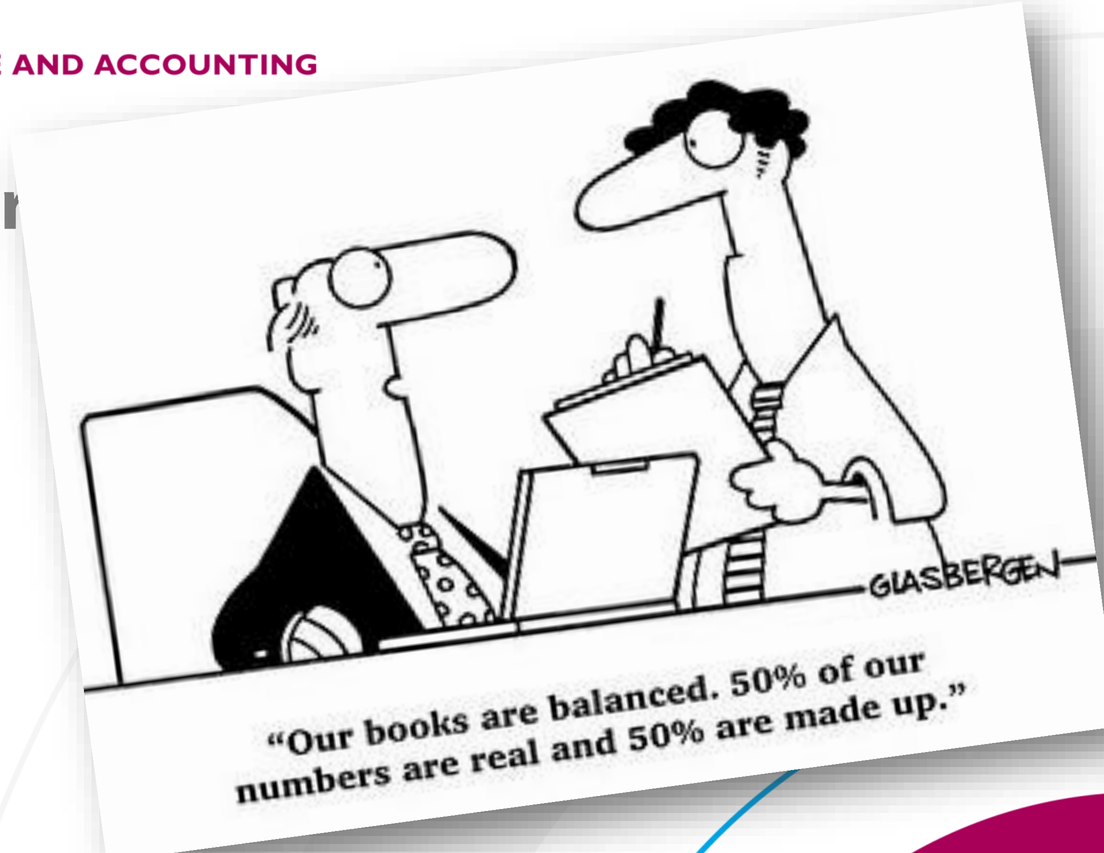
Thank you for your attention…

…and I will be happy to answer your questions!



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