Non-Recognition of Provision for Obligations

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Introduction

XYZ is a company which is incorporated in implementing many projects in Sri Lanka. Under that there is a project which is engaging in providing credit guarantees to Participating Financial Institutions (PFIs). In this article included an issue related with the Identification of provision separately from contingent liability with the analysis in accordance with the LKAS and provides relevant accounting treatments.

Discussion of the Issue

XYZ is giving coverage to PFIs based on default amount of pawning advances. It was noted that XYZ has recognized contingent liability for cover to credit guarantee. The maximum liability is 17.81% of the value of gold articles. As well as they identify defaults of pawning advances after 15 months from the date of pawning advance and PFIs shall submit a claim form within 30 days of default to the XYZ.

XYZ identified contingent liability for their coverage and disclose in financial statement as at 31st December 20X0 relating to the project. Following example show how to calculate maximum liability.

Pawning Article Value	**Granted Amount**	**Interest Rate**	**Period (months)**	**Total Interest**	**Total Exposure**
100	65	15%	15	12.19 (65*0.15/12*15)	77.19(65 +12.19)
100	80	15%	15	15	95

Maximum liability = 95 – 77.19
= 17.81%

E.g. – PA Company has Rs. 500,000 worth pawning articles. Then XYZ gives credit guarantee for PA Company and XYZ identify contingent liability in following way,

= 500,000 * 17.81%
= Rs.89, 050

The identification of contingent liability was complying with accounting standard. Because, According to LKAS 37 paragraph 10(a),

A contingent Liability is,
"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 entity."

According to LKAS 37, provision need to be recognizes after 15 months but XYZ not recognize and disclosure any provision in their financial statement if such claims meet the recognition criteria mentioned in LKAS 37.

Implication of the Issue

The recording of provision affects both statements of financial position as well as a Statement of Comprehensive Income. Accounting for provision may adversely affect to profitability of the company. Provision is considered as a liability of the company and increasing provision means increase in liability.

Conclusions and Recommendations

According to the LKAS 37 in paragraph 14, provision shall be recognized when;

a.) An entity has a present obligation as a result of a past event;

b.) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and

c.) A reliable estimate can be made of the amount of the obligation

As per the issue mentioned in above, the management should need to identify provision after 15 months base on values in claim forms by using calculation method as they used to calculate contingent liability because issued coverage meet the provision recognition criteria given under LKAS 37. Those criteria are summarized as follows in an applicable way to the XYZ,

- Present obligation as a result of a past obligation event **-** XYZ receive claim forms after 15 months of period from PFIs. On the basis that evidences available there is a present obligation as a result of past event
- An outflow of resources embodying economic benefits in settlement – probable
- A reliable estimate can be made of the amount of the obligation – XYZ can reliable estimate the amount of the obligation based on the claim forms.

Then it is recommended to recognized provision of the amount to settle the obligation.