Understanding the measurement of the **best estimate** of long-dated provisions in accordance with IAS *37 Provisions, Contingent Liabilities and Contingent Assets*

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Addis Ababa

WORLD BANK GROUP

AABE

Accounting and Audit Board of Ethiopia

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Aim

» The aim of this session is to enhance knowledge and understanding, in the Ethiopian accountancy market, of the best estimate of long-date provisions measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

» *[Note: the valuation session that follows after the coffee break is dedicated to enhancing skills in the Ethiopian accountancy market in the practical application of IAS 37 to measuring the best estimate of long-date provisions in the Ethiopian context.]*

What does 'best estimate' measurement capture?

What does ‘best estimate’ measurement capture?

- **Principle:** best estimate of a liability is the amount that an entity would, at the measurement date, **rationally pay**:
  - (i) to settle the obligation (entity-specific measure); or
  - (ii) to transfer it to another party (market-based measure).
- Measuring the best estimate of a liability requires **judgement**.

Source: paragraphs 37 and 38 of IAS 37

Which liabilities are measured at ‘best estimate’?

Which liabilities are measured at 'best estimate'?
Summary of class discussion

IFRS Accounting Standard	At initial recognition	Subsequent measurement	Disclosure only (unrecognised liabilities)
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	Provision	Provision	Contingent liability

Provision or contingent liability?

Classification	Nature of the liability–a present obligation…
Provision	…of uncertain timing or amount.
	(Provisions also include onerous contracts–a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)
Contingent liability	…of uncertain timing or amount that is not recognised because it fails the recognition criteria.
	(Contingent liabilities also include possible obligations.)

Provision or contingent liability?
Recognition criteria

- Recognise a provision liability when:
  - reporting entity has a **present obligation** (legal or constructive) **or deemed present obligation** (when uncertain but it is more likely than not that a present obligation exists);
  - **more likely than not** that resources required to extinguish; and
  - a **reliable estimate** can be made of the amount of the obligation.

Source: paragraphs 14 and 15 of IAS 37

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Which measurement applies to liability at 31/12/2022?
Example 1: manufacturing defects
Summary of class discussion

- A computer manufacturer promises to make good any manufacturing defects in the products it sells that are returned to it within five years of the date of sale. At 31/12/2022 the entity:
  - had **sold** 10 million computers over the past five years; and
  - has 1 million computers in **inventory**.
- **Which measurement applies to liability at 31/12/2022? For 10 million computers sold:** 1) best estimate (provision 'on-balance sheet'); 2) best estimate (contingent liability 'off-balance sheet'); 3) it depends…
- Note: at 31/12/2022 there is no liability regarding the computers in inventory.

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Which measurement applies to liability at 31/12/2022?
Example 2: environmental damage
What do you think?

» Following a catastrophic rupture of its tailings dam early in 2022 Miner has no legal obligation to clean-up the polluted environment.

» However, on 30/12/2022 (before Miner's 31/12/2022 annual financial statements are authorized for issue) Miner **makes a public announcement** that it will clean-up the polluted environment even though in law (of that jurisdiction) it is not required (has no legal obligation) to cleanup. Consequently, Miner has no realistic way of avoiding the clean-up costs.

» **Which measurement applies to liability at 31/12/2022?** Choose one of: 1) best estimate (provision 'on-balance sheet'); 2) best estimate (contingent liability 'off-balance sheet'); 3) it depends…

Which measurement applies to liability at 31/12/2022?
Example 2: environmental damage
Summary of class discussion

Which measurement applies to liability at 31/12/2022?
Choose one of:

1) best estimate (provision 'on-balance sheet');
2) best estimate (contingent liability 'off-balance sheet');
3) Assuming that the extinguishment outflow is more likely than not, **it depends** on whether Miner can **reliably estimate** the liability. (Contingent liability only in the **extremely rare** circumstance that it cannot measure reliably).

Which measurement applies to liability at 31/12/2022?
Example 3: lawsuit
What do you think?

» At 31/12/2022 the reporting entity is the defendant in a breach of patent lawsuit in which the court is determining the **extent of the damages** to be paid by the reporting entity (the entity has admitted breaching the patent).

» **Which measurement applies to liability at 31/12/2022?** Choose one of: 1) best estimate (provision 'on-balance sheet'); 2) best estimate (contingent liability 'off-balance sheet'); 3) it depends…

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Which measurement applies to liability at 31/12/2022?
Example 3: lawsuit
Summary of class discussion

Which measurement applies to liability at 31/12/2022?
Choose one of:

1) best estimate (provision 'on-balance sheet');
2) best estimate (contingent liability 'off-balance sheet');
3) it depends. Because extinguishment outflow is more likely than not, depends on whether entity can reliably estimate the liability. (Contingent liability only in the **extremely rare** circumstance that it cannot measure reliably).

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Which measurement applies to liability at 31/12/2022?
Example 4: decommissioning obligation
What do you think?

» On 31/12/2022 the reporting entity completed the construction of its hydro power plant. As a consequence of constructing the power plant the entity is **legally obliged to decommission** the plant at the earlier of 50 years or when it ceases generating power from the plant for a period of greater than three months.

» **Which measurement applies to liability at 31/12/2022?** Choose one of: 1) best estimate (provision 'on-balance sheet'); 2) best estimate (contingent liability 'off-balance sheet'); 3) it depends…

Which measurement applies to liability at 31/12/2022?
Example 4: decommissioning obligation
Summary of class discussion

Which measurement applies to liability at 31/12/2022?
Choose one of:

1) best estimate (provision 'on-balance sheet');
2) best estimate (contingent liability 'off-balance sheet');
3) it depends. Because extinguishment outflow is more likely than not, depends on whether entity can reliably estimate the liability. (Contingent liability only in the **extremely rare** circumstance that it cannot measure reliably).

Ethiopian context

Ethiopian context: Which long-dated non-financial, non-employee benefit liabilities do Ethiopian companies have?

Summary of class discussion

» Product warrantees

» Legal, e.g. defendants in court cases

- » https://investmentpolicy.unctad.org/investment-dispute-settlement/country/67/ethiopia/respondent
- » https://ethiopianbusinessreview.net/arbitration-commercial-dispute-settlement-mechanism/

Ethiopian context
Example 1 Commercial Bank of Ethiopia: Extract from Consolidated Statement of Financial Position as at 30 June 2021 (Birr)

Liabilities			
Deposits due to other banks		364,945,567	1,109,055,430
Customers' deposits	21	735,295,983,493	593,041,145,062
Current tax liabilities	25	6,337,242,247	5,954,265,633
Provisions	22	1,528,010,488	1,389,959,157
Finance lease obligations	20	394,843,317	249,694,124
Dividends	24	9,571,909,473	7,771,189,170
Employee benefits	23	6,459,952,329	6,614,840,691
Other liabilities	24	177,539,624,174	153,326,630,375
Total Liabilities		**937, 492, 511, 088**	**769,456,779,642**

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Ethiopian context: provisions
Example 1 Commercial Bank of Ethiopia: Extract from Notes to the Consolidated Financial Statements 30 June 2021

(22) PROVISIONS

	Bonuses	Cash Prize Award	Legal	Unutilized O/D,LC and Guarantee	Total
Balances at 30 June 2019	548,285,021	-	64,916,278	48,828,844	662,030,144
Increases (decrease) recorded in income	525,035,191	116,563,214	80,950,417	5,380,191	727,929,013
Balances at 30 June 2020	**1,073,320,212**	**116,563,214**	**145,866,695**	**54,209,036**	**1,389,959,157**
Increases (decrease) recorded in income	1,141,551,353	122,891,273	(10,002,174)	67,894,171	1,322,334,624
Provisions used during the year	(1,065,203,434)	(116,563,214)	(2,516,643)	-	(1,184,283,291)
Balances at 30 June 2021	**1,149,668,131**	**122,891,273**	**133,347,878**	**122,103,206**	**1,528,010,488**

Bonus represent short-term benefits arising from past services provided by employees and are expected to pad within the next 12 months.

Legal provisions represent various claims that are pending outcome at the courts. These amounts are estimates of the likely legal claims that may not be ruled in the Group's favor.

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Ethiopian context: Contingent liabilities
Example 2 Ethiopian Airlines Group: Extract from Notes to the Financial Statements 30 June 2021

34 Contingent Liabilities

Ethiopian Airlines Group has contingent liabilities, not provided for in these financial statements of Birr 853,310,936.71 in respect of legal actions brought by different organizations and individuals, which are being contested by Ethiopian Airlines Group. It is not possible to determine the outcome of these cases.

Measuring the best estimate of a provision

Liability measurement provision and disclosure of contingent liability best estimate

» **Principle:** best estimate is the amount that an entity would at the measurement date **rationally pay**:
- » (i) to settle the obligation; or
- » (ii) to transfer it to another party

» **Application guidance:**
- » **large population** of items: expected value approach must be used
- » **single obligation:** individual most likely outcome but adjusted for other possible outcomes
- » take account of all risks and uncertainties specific to the liability

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Non-financial liability measurement example: best estimate of a large population of items

» In 2023 a digital hearing aid manufacturer sold one million hearing aids.

» At 31/12/2023, on the basis of experience, the manufacturer assigns probabilities to its estimates of the possible outcomes arising from its obligation to make good manufacturing defects discovered within twelve months of sale.

	Probability of occurrence	Probability of return	Risk adjusted estimated cost to fix a defect
Minor defect	10%	1%	ETB30
Medium defect	2%	50%	ETB300
Major defect	1%	100%	ETB2,000
No defect	87%		

Non-financial liability measurement example: best estimate of a large population of items
Summary of class discussion

» At 31/12/2023, in accordance with IAS 37, the manufacturer uses the expected value method to measure its obligation, as follows:

Defect	Calculation	ETB
Minor	1,000,000 units x 10% x 1% x ETB30	ETB30,000
Medium	1,000,000 units x 2% x 50% x ETB300	ETB3,000,000
Major	1,000,000 units x 1% x 100% x ETB200	ETB20,000,000
None	1,000,000 units x 87% x nil	ETB0
Total		**ETB23,030,000**

Why, in this example, is the $23,030,000 not discounted to its present value? No discounting because settled within 12 months after the year in which it accrues.

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Non-financial liability measurement example: best estimate of a single obligation

» At 31/12/2023 expert legal council assigns probabilities to their estimates of the possible outcomes of a patent infringement lawsuit that the reporting entity is defending.

» The court is expected to rule in about eight months.

Level of damages awarded by court	Probability of occurrence	Risk adjusted estimated damages
Low	50%	ETB1,000,000
Medium	20%	ETB10,000,000
High	20%	ETB100,000,000
None	10%	

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Non-financial liability measurement example: best estimate of a single obligation

What do you think?

At 31/12/2023, in accordance with IAS 37, the manufacturer could measure its obligation at? Choose one of:

	Calculation	ETB
(1)	Expected value (50% x ETB1,000,000) + (20% x ETB10,000,000) + (20% x ETB100,000,000) + (10% x ETB0)	ETB22,500,000
(2)	Most likely outcome	ETB1,000,000
(3)	Possible outcome closest to expected value	ETB10,000,000
(4)	Least favourable possible outcome for reporting entity	ETB100,000,000
(5)	Most favourable possible outcome for reporting entity	ETB0
(6)	Another amount	Specify

Provision (liability) measurement best estimate of a single obligation: inconsistent interpretation

Summary of class discussion

» The IASB staff has observed significant inconsistencies in the biggest accountancy firms' interpretations of the meaning of best estimate for a single obligation

» **PwC:** expected value might equally be applied to a single obligation with various possible outcomes. **Deloitte and KPMG:** expected value is **not a** valid technique for single obligations.

» **Deloitte:** uses most likely outcome if close to expected value otherwise uses whichever possible outcome is nearest to the expected value.

» **KPMG:** usually most likely outcome is best estimate of a single obligation.

» **EY:** make adjustment from most likely outcome but does not suggest how to do so.

(see paragraph 3.6 of Agenda Paper 14B for the July meeting of the IASB)

Provision (liability) measurement
best estimate of a single obligation
Summary of class discussion

» **Which of the accounting firms do you think most clearly interprets the requirements for measuring best estimate of a single obligation?**

Choose one of: 1) PwC; 2) Deloitte; 3) KPMG; or 4) EY.

» **On the basis of the preceding example, do you believe the firms views to be valid interpretations of the requirements?**

1) PwC (choose one of): 1) Yes; or 2) No.
2) EY (choose one of): 1) Yes (but how to?); or 2) No.
3) Deloitte (choose one of): 1) Yes; or 2) No (outcome in this example seems inconsistent with measurement principle).
4) KPMG (choose one of): 1) Yes; or 2) No (outcome of 'usual approach' in this example seems inconsistent with measurement principle. Does this example illustrate when the usual outcome does not apply?).

FRC(UK) regulatory mini-case study:
Better practice observation: best estimate (and uncertainties)

Extract from The Weir Group PLC, Annual Report and Financial Statements 2020, p180 (emphasis added)

"The actuarial model provides a range of potential liability based on levels of probability from 10% to 90%, which, on an undiscounted basis, equates to £53m-£133m. The mean actuarial estimate of £91m represents the expected undiscounted value over the range of reasonably possible outcomes. The provision in the financial statements is based on the **mean actuarial estimate** which is then **adjusted to reflect discounting** and restricting our estimate to ten years of future claims."

FRC(UK): "This disclosure put the point estimate in the context of a range, with clear boundaries representing 'reasonably possible' outcomes, and explained how the mean value relates to the best estimate."

Source: FRC(UK) Thematic Review: IAS 37, Appendix. Case study: 'best estimate', uncertainties and significant judgements, October 2021 (p19)

FRC(UK) regulatory mini-case study:
Better practice observation: best estimate **key sources of estimation uncertainty**

Provisions for restoration and decommissioning obligations are made based on the best estimate of the likely committed cash outflow. Management seek specialist input from third party experts to estimate the cost to perform necessary remediation work at the reporting date. These experts undertake site visits in years where scoping identifies there is a change in operations in the year which could suggest a change in these estimates, or at sites that have not been visited recently. Desktop reviews are undertaken to inform the estimates for other sites. If the cost estimates increased by 10% the value of provisions could change by c.£1.2m. The useful lives of quarrying sites are based on the estimated mineral reserve remaining and manufacturing facilities linked to the useful life of site property, plant and equipment. Changes to these useful lives do not have a significant impact on the provision.

The estimation of inflation and discount rates is also considered to be judgemental and can have a significant impact on net present value. Management reference information from the Bank of England when making such estimates. If the discount or inflation rate were changed and the spread between them increased by 1% the value of provisions could change by c.£2.5m.

Forterra PLC,
Annual Report and Accounts 2020, p142

This company clearly set out its methodology for estimating the outflow, using current costs as determined by third party experts from site visits where there is likely to be greater uncertainty owing to changes in operations or passage of time.

Sensitivity disclosure addressed changes in estimated costs and the spread between the discount rate and inflation.

The comment on useful lives of quarrying sites and of property, plant and equipment at manufacturing facilities is informative even though changes to these lives do not have a significant effect. The disclosure provides a reasonable indication that the expected timing of outflows, estimated from current costs, is not a critical source of uncertainty compared to the absolute amounts estimated or the rate at which future outflows are discounted to present value.

This disclosure noted the source for the 'time value of money' (risk-free) component of the discount rate. The accounting policy for provisions explained that the discount rate is adjusted for risks specific to the liability.

Source: FRC(UK) Thematic Review: IAS 37, Appendix. Case study: 'best estimate', uncertainties and significant judgements, October 2021 (p26)

Liabilities
selected judgements and estimates

Provisions and contingent liabilities: IAS 37

Classification:

- determining whether present obligation (provision) or possible obligation (contingent liability) exists
- to classify a present obligation as either a provision or a contingent liability, ie determining
  - whether it is more likely than not (ie > 50% probability) that resources will flow from the entity to extinguish the present obligation; and
  - whether the obligation can be measured reliably (extremely rare circumstances).

Liabilities
selected judgements and estimates

Provisions and contingent liabilities: IAS 37
Measurement:
• measuring the best estimate of a provision (or, for disclosure only, a contingent liability)
Disclosure:
• identifying extremely rare circumstances when 'normal' disclosures can be expected to prejudice seriously the position of the entity in a dispute (alternative disclosures apply)

Mini-case study: measuring the best estimate of long-dated provisions

Measuring the fair value of an asset retirement obligation
Mini-case study

- Reporting Entity (RE) must start remediating its opencast gold mine site no later than when its non-transferable extraction licence expires in 9 years time. It cannot transfer the obligation to another. Rehabilitation must be completed in no longer than 2 years. Management expects costs will be incurred evenly over the 2-year remediation period.
- Management has developed three technology dependent scenarios of the costs (direct, allocated overhead and equipment) it expects to incur to remediate the mine:
  - **Optimistically realistic** (20% probability): ETB6 billion
  - **Most likely** (50%): ETB10 billion
  - **Pessimistically realistic** (30%): ETB12 billion

Measuring the fair value of an asset retirement obligation
Mini-case study (continued)

- Were RE able to transfer the obligation to a 3rd party, on the basis of relevant industry data, the 3rd party:
  - **costs** would likely be 10% less than those RE expects to incur
  - would command a **5% risk premium** (for the uncertainties in the future mean cash flow projections)
  - would likely command a **25% margin** on its costs.
- Forecast inflation (on the basis of market data) for the jurisdiction = 3% p.a.
- Discount factor = 7%

Measuring the fair value of an asset retirement obligation example

Summary of class discussion (continued)

	Optimistic	Most likely	Pessimistic
Reporting Entity cost estimates	6	10	12
Adjustment to market participant costs (10%)	(.6)	(1)	(1.2)
Market participant cost estimates	**5.4**	**9**	**10.8**
Contractor risk premium (5%) and profit (25%)	1.62	2.7	3.24
Market participant price without inflation	**7.02**	**11.7**	**14.04**
Inflation adjusted @ 3% (ie x 1.34391638)	**9.434**	**15.724**	**18.869**
Probability	20%	50%	30%
Probability weighted = ETB**15,409,345**	**1.887**	**7.862**	**5.661**
Present value @ 7% (ie 0.50834929) = ETB7,833,329.7			

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FRC(UK) regulatory mini-case study

FRC(UK) regulatory mini-case study: Best estimate, uncertainties and significant judgements (1 of 3 slides)

"A regulator in XYZ plc's largest market has challenged the company's business practices. Precedents from similar actions suggest that the regulator is **more likely than not** to impose a large fine (material to XYZ plc). An appeal process may result in a fine smaller or larger than that originally proposed.

Legal advisors to XYZ plc believe that the outcome, if adverse, will follow a set of precedent cases with no discernible bias towards a high or low value in that range. The appeal court may give weight to other factors leading to a materially higher or lower fine, for example: XYZ plc's conduct during the case, changes in business practices and emerging public interest issues. It is only remotely likely that the penalty will be either nominal or punitive.

Interim hearings in the next twelve months are expected to provide stronger indications of the court's attitude. A final decision will take up to four years.

Source: FRC(UK) Thematic Review: IAS 37, Appendix. Case study: 'best estimate', uncertainties and significant judgements, October 2021 (p38)

FRC(UK) regulatory mini-case study: Best estimate, uncertainties and significant judgements (2 of 3 slides)

"Management has assessed the likelihood of an adverse outcome to be **close to 50/50**. A critical factor is the weight given to new legal arguments in XYZ plc's favour. Management judges that a provision is required, on the critical assumption that the court is more likely than not to reject these arguments.

There is **significant risk** that as a result of the interim hearings:

» either the best estimate for the provision will move to the top or bottom of the current 'probable' range, requiring a material adjustment; or

» management's judgement will change to regard the adverse outcome as only possible, leading to release of the entire provision (i.e. a material adjustment) and disclosure of a contingent liability."

Source: FRC(UK) Thematic Review: IAS 37, Appendix. Case study: 'best estimate', uncertainties and significant judgements, October 2021 (p38)

FRC(UK) regulatory mini-case study: Best estimate, uncertainties and significant judgements (3 of 3 slides)

What do you think?

What are the main considerations in accounting for and disclosing the significant judgement applied to the circumstances and the uncertainty as to the amount of potential outflow across the range of possible outcomes?

Significant judgement (paragraph 122 of IAS 1)	
Range of outcomes, across entire spectrum of probability	
Recognition	
Measurement	
Disclosure about uncertainty (paragraph 85 of IAS 37)	
Key source of estimation uncertainty (paragraph 125 of IAS 1)	

FRC(UK) regulatory mini-case study: Best estimate, uncertainties and significant judgements (3 of 3 slides)

The diagram below indicates the main considerations in disclosing the significant judgement applied to the circumstances and the uncertainty as to the amount of potential outflow across the range of possible outcomes.

Significant judgement (IAS 1, paragraph 122)	Exercised in assessing whether there is a probable present obligation: were management to prefer the alternative view on new legal arguments, the obligation to pay anything would be considered only possible and no provision would be recognised.				
Range of outcomes, across entire spectrum of probability	Nominal penalty only remotely likely	Smaller payout possible, taking account of mitigating factors	Probable payout range based on precedent cases, assumed to carry equal weight across the range	Larger payout possible	Punitive fine only remotely likely
Recognition	No provision	No provision	Provision recognised	No additional provision	No provision
Measurement	N/A	Estimate of minimum 'possible' payout, relevant for indication of uncertainty	'Best estimate' amount, in this case at mid-point within probable payout range	Estimate of maximum 'possible' payout, relevant for indication of uncertainty	N/A
Disclosure about uncertainty (IAS 37, paragraph 85)	No disclosure	'Indication of uncertainty' addresses the range of possible outcomes of an adverse decision, looking beyond the probable range and considering the overall timeframe for resolution of the matter			No disclosure
Key source of estimation uncertainty (IAS 1, paragraph 125)			Key estimation uncertainty (outcome of interim hearings) affecting following financial year		

Source: FRC(UK) Thematic Review: IAS 37, Appendix. Case study: 'best estimate', uncertainties and significant judgements, October 2021 (p38)