ACCOUNTING GUIDELINE

GRAP 19

Provisions, Contingent Liabilities and Contingent Assets

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Contents

****new section added on executory contracts and disclosures on commitments, see page 26 and a new section on grant agreements and accounting for the “return right”, see page 29.**

1. Introduction

This document provides guidance on the recognition and measurement of provisions, as well as the disclosures related thereto. It also provides guidance on the information to be disclosed in the notes to the financial statements about contingent liabilities and contingent assets. The contents should be read in conjunction with GRAP 19. For purposes of this guide, "entities" refer to the following bodies to which the standard of GRAP relate to, unless specifically stated otherwise:

- Public entities
- Constitutional institutions
- Municipalities and all other entities under their control
- Trading entities and government components applying the standards of GRAP
- Parliament and the provincial legislatures
- TVET and CET colleges

Explanation of images used in manual:

	Definition
	Take note
	Management process and decision making
	Example

2. Scope

GRAP 19 is applicable to all entities preparing their financial statements on the accrual basis of accounting. The following are excluded from the Standard:

- Those provisions and contingent liabilities arising from social benefits provided by an entity 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;

Social benefits include:

- the delivery of health, education, housing, transport and other social services to the community; and
- payment of benefits to families, the aged, the disabled, the unemployed etc.

- Those resulting from executory contracts, other than where the contract is onerous;

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (also known as a commitment).

- Those covered by other standards, for example:
    - GRAP 104 on *Financial Instruments*;
    - GRAP 11 on *Construction Contracts*;
    - GRAP 13 on *Leases* (except leases that are onerous);
    - GRAP 25 on *Employee Benefits*;
    - GRAP 106 on *Transfer of Functions Between Entities Under Common Control* (for contingent considerations of an acquirer in a transfer of functions between entities not under common control);
    - IFRS 4® Standard on *Insurance Contracts*;
    - IAS 12® Standard on *Income Taxes*.

3. Definition and Identification

A provision is a liability of uncertain timing or amount.

Liabilities are present obligations, arising from past events, the settlement of which is expected to result in an outflow of economic benefits or service potential.

3.1 Difference between provisions, accruals and payables

The difference between provisions and other liabilities is that there is uncertainty about the timing or amount needed to settle the obligation. As opposed to:

- Payables, where the goods and services have been invoiced or formally agreed with the supplier; and
- Accruals, where the goods and services have been received but have not been invoiced or formally agreed with the supplier, including amounts due to employees. Although the amount or timing may need to be estimated, there is much less uncertainty involved.

Accruals should be reported as part of trade and other payables, whereas provisions are reported separately in the statement of financial position.

Classification of leave as an accrual or a provision

The leave liability will be treated as an accrual or a provision depending on the level of uncertainty attached to either the timing or amount, the less uncertainty, the more likely that the liability will be an accrual.

Consider the following examples in which cases the leave liability will be an accrual:

Entity L's leave policy states: "If an employee doesn't take his/her leave within one year of it accumulating to him/her, the outstanding leave days will be paid it out in cash at the end of that year."

When the leave is accrued to the employee, management is legally (through its policy) bound to compensate the employee for the leave. There is no uncertainty of timing or amount. Economic benefits will flow out as a result of this leave. This leave should be accounted for as an accrual.

If, however, Entity P's leave policy states: "If an employee doesn't take his/her leave within one year of it accumulating to him/her, it will be forfeited."

It can with reasonable certainty be assumed that no one is willing to forfeit their leave as such, when applying rationale it is clearly highly likely that an employee will consume his/her entire leave entitlement prior to the expiry thereof.

Once again, the leave is accounted for as an accrual, because the uncertainty (is he/she going to take it? / is he/she going to take it within this year?) has been removed. Thus there is no uncertainty to warrant a provision.

Consider the following examples in which cases the leave liability will be a provision:

Entity L's leave policy states: "Any unused leave will be forfeited if not used within six months after the annual leave cycle has expired."

In this case, timing is certain (within six months after the annual leave cycle has expired), but the amount may be uncertain (i.e. an estimate of the leave that will be forfeited should be made in measuring the liability). Management should use its judgement in deciding whether the uncertainty is more or less in measuring the liability, if the preceding is true, then the leave liability should be recognised as a provision.

If, however, Entity P's leave policy states: "Any unused leave will be paid out upon retirement or death."

This is capped leave and in this case there is more uncertainty about the timing and amount (when is the employee going to retire). Thus there is uncertainty to warrant a provision.

For more detail on the recognition and measurement of the leave liability, refer to the accounting guideline on GRAP 25.

Classification of bonus as an accrual or a provision

The bonus payable will be treated as an accrual or a provision depending on the level of uncertainty attached to the timing or amount, the less uncertainty, the more likely that the liability will be an accrual.

Consider the following example in which case the bonus payable will be an accrual:

Entity B pays out bonuses in the form of 13th cheques in December each year, which is equal to one month's salary (cost to company). If an employee only worked for part of the year, the bonus will be calculated pro-rata based on the actual months employed.

There is no uncertainty regarding the amount to be paid out nor the timing of the outflow of economic benefits, therefore the bonus should be accounted for as an accrual.

Consider the following example in which case the bonus payable will be a provision:

Entity B's HR policy states: "Employees are entitled to a performance bonus payable every six months equal to 15% of the employee's salary (cost to company) for six months. The performance bonus is only payable subject to the following conditions:

- The employee has met the targets as required in their performance contracts;
- If the employee only worked for part of the year, the performance bonus payable every six months is calculated pro-rata based on the actual months employed; and
- The entity has sufficient funds available to pay out performance bonuses."

In this case, timing is certain (every six months), but the amount may be uncertain (will the employee meet the targets and will the entity be able to pay out bonuses). An estimate of the performance bonus should be made in measuring the liability. Thus there is uncertainty to warrant a provision.

For more detail on the recognition and measurement of the bonuses payable, refer to the accounting guideline on GRAP 25.

Remember that the terms 'allowance for impairment' (provision for bad/doubtful debts), 'provision for obsolete stock/inventory', and any other similar 'provisions' are not actual provisions as meant in GRAP 19.

For instance 'allowance for impairment' is actually an impairment of debtors and is accounted for in accordance with GRAP 104 on *Financial Instruments*. Similarly, 'provision for obsolete stock/inventory' is actually an impairment of inventory and is accounted for in accordance with GRAP 12 on *Inventories*.

Example: Distinguishing between different liabilities and contingencies

Entity ABC has the following transactions at year end (March) which the accountant is unsure as how they need to be treated:

- Monthly telephone contract at Telkom for R500 for which the March invoice was not yet received.
- An invoice for a new printer received in March of R2,000 which only needs to be settled at the end of the next month.
- A potential claim from an employee for breaking her arm while performing her work duties of R20,000.
- PAYE of R35,000 for the month of March which will only be paid over to SARS in April of the next financial year.

The liabilities will be treated as follows:

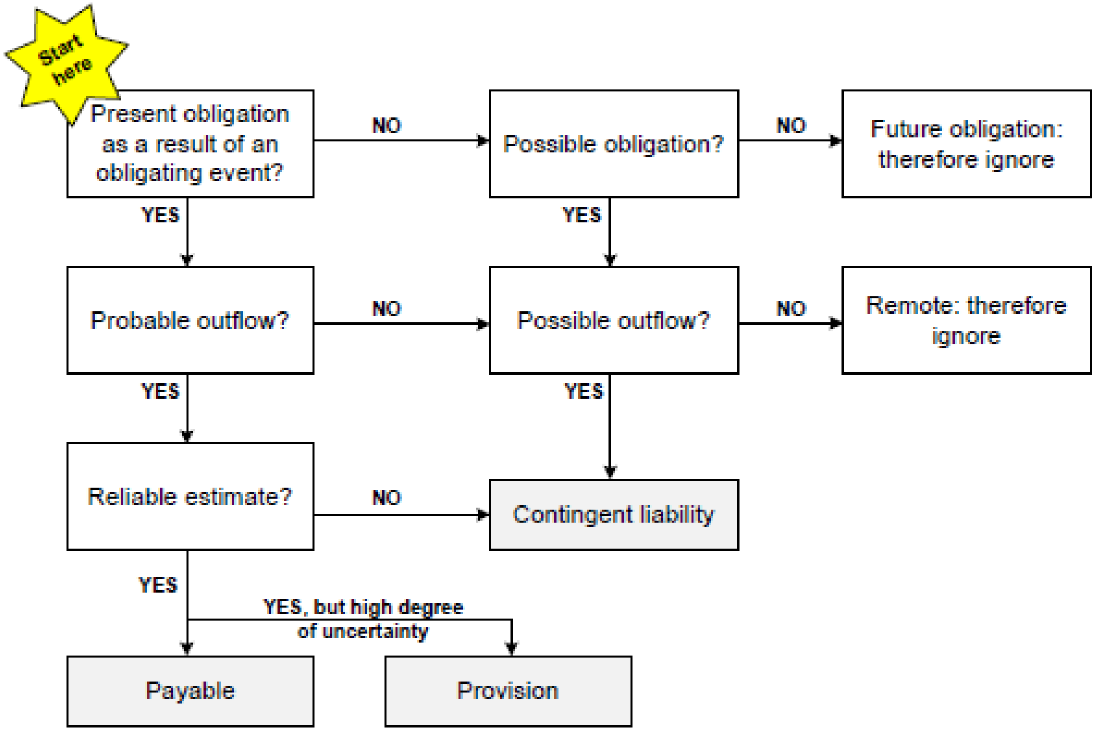
a) At year end the entity has an obligation to pay the monthly telephone contract payment of R500 as the department already received the services from Telkom at year end. The R500 will therefore be recorded as an accrual.

b) At year end the entity has an obligation to pay for the printer as the entity already received the printer, however payment only needs to be made after year end. The amount will therefore be recorded as a payable.

c) At year end it is not yet probable whether the entity would need to reimburse the employee for breaking her arm at work. The entity has a possible obligation which will be confirmed after the lawsuit or claim has been finalised. This is therefore a contingent liability as the obligation is not probable at year end. The entity will disclose a contingent liability of R20,000.

d) At year end the entity has an obligation to pay the R35,000 over to SARS. The R35,000 will be recorded as a payable.

The following decision tree can be used to distinguish between a payable (or accrual), provision and a contingent liability:



4. Provisions

A provision should only be recognised when all of the following criteria are met:

- 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** of the amount of that obligation can be made.

4.1 Present obligation

A present obligation is an existing duty or responsibility to perform which can stem from a binding arrangement ("legal obligation") or may be constructive in nature ("constructive obligation").

In some cases it may not be clear if a present obligation exists. In such cases it should be determined if there was a past event giving rise to a present obligation. This is discussed in more detail in the following section.

A binding arrangement is an arrangement that confers enforceable rights and obligations on the parties to the arrangements as if it was in the form of a contract. It includes rights from contracts or other legal rights.

Binding arrangements can be evidenced in several ways:

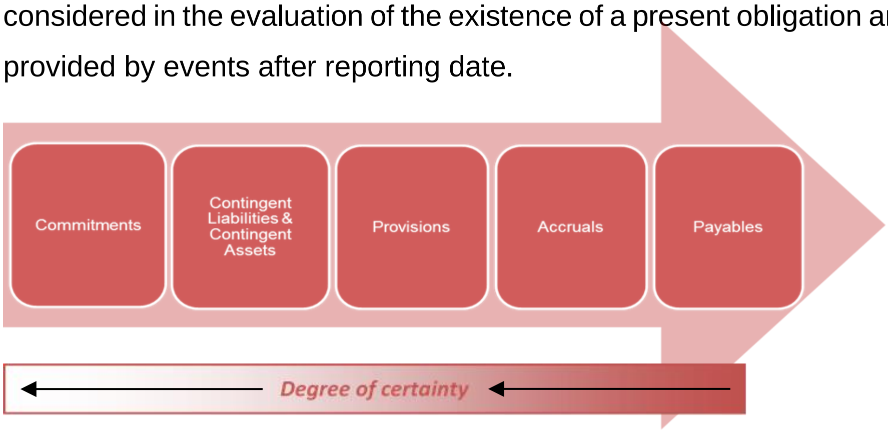
a) A contract concluded between parties;

b) Legislation, supporting regulations or similar means including, but not limited to laws, regulations, policies, decisions concluded by authorities such as cabinet, executive committees, boards, municipal councils and ministerial orders; or

c) Through the operation of law, including common law.

A binding arrangement is often, but not always, in writing, in the form of a contract or documented discussions between parties.

In certain situations the existence of a past event might be disputed (for example in a court case there might be a dispute over the occurrence or non-occurrence of a past event), which may cast doubt on the existence of a present obligation. All available evidence must be considered in the evaluation of the existence of a present obligation and this includes evidence provided by events after reporting date.



4.2 Past event

A past event that leads to a present obligation is called an obligating event. This is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling the obligation.

The question one can consider to determine if an obligating event exists is: Can I walk away from this? If the answer is yes, then no present obligation exists.

An obligating event can occur in either of the following instances:

- **Legal** obligation **-** arises when the settlement of the obligation can be enforced by law. For example: Entities that are registered for VAT have a legal obligation to pay a certain percentage of their vatable revenue to the Receiver of Revenue (SARS). That obligation exists in terms of the Value-Added Tax Act. Obligations can also arise in terms of a contract, for example an employment contract.

- **Constructive** obligation **-** arises where past practices creates a valid expectation on the part of a third party and the entity may have no realistic alternative but to incur the expense. For example: Entity A does not have a contract in place that states that employees are entitled to a bonus (in the form of a 13th cheque), however it has been the entity's practice for the last few years to pay bonuses to employees in December. Entity A has a constructive obligation to pay bonuses that was created due to its past practices.

Financial statements are a snapshot of the financial position of an entity on a specific date and not its possible position in the future. Thus, provisions should not include costs to be incurred to continue an entity's ongoing activities in the future.

Example: Past event

Management is planning a maintenance program at four of its water reticulation plants in two years' time. The anticipated cost is R250,000. Planning for future expenditure does not establish an obligating event. The intention to incur future maintenance costs does not create a constructive obligation or a legal obligation and no liability should be recognised.

A probable outflow will only arise once the maintenance plan has been implemented, at which point the entity will begin to recognise liabilities.

An obligation always involves another party to whom the obligation is owed. A decision by management or council will not give rise to a constructive obligation, unless the decision is communicated sufficiently to those affected before the reporting date in such a way that it raises a constructive obligation, i.e. the entity would have no realistic alternative but to go through with it.

Example: Warranties

Entity A manufacturers search and rescue equipment for use and for sale to the public. At the time of sale, Entity A gives warranties to purchasers in relation to certain products. Under the terms of the sale, Entity A undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable that there will be some claims under the warranties.

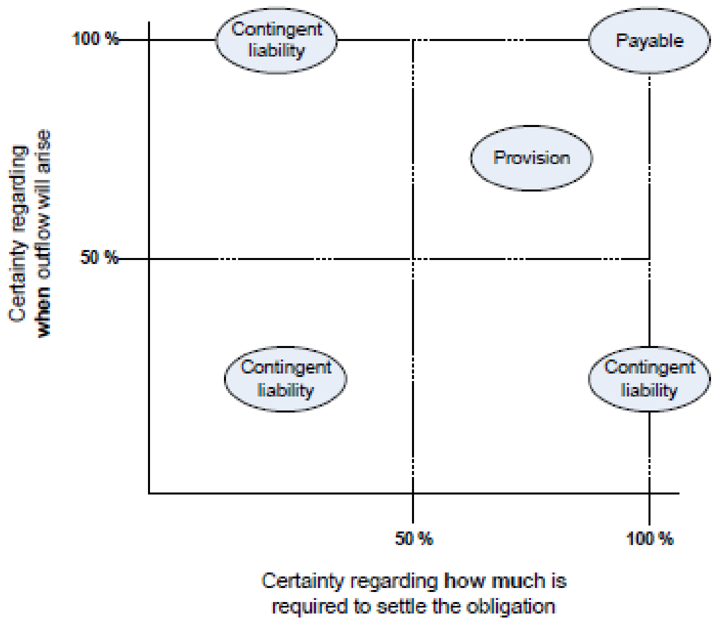
An obligating event arises when the product is sold (a legal obligation), due to the probability that there will be an outflow of resources (past experience) a provision is recognised for the best estimate of the costs of making good under the warranty products sold on or before the reporting date.

4.3 Probable outflow of resources embodying economic benefits or service potential

A third characteristic of a liability, is the probability of an outflow of economic benefits or service potential. A liability arises when the department has little or no alternative to avoid an outflow of economic benefits and service potential. The outflow of resources is recorded as a provision, depending on the uncertainty involved with regards to timing or amount, in the year in which the outflow becomes probable.

The term “probable” is interpreted as an outflow of economic benefits or service potential being “more likely than not” to occur, that is, the probability that the event will occur is greater than the probability that it will not. It can thus be inferred that if the likelihood of an outflow is 50% or less then the obligation is only “possible”.

Where it is not likely that a present obligation exists, a contingent liability may have to be disclosed.



5. Measurement of Provisions

5.1 Best estimate

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the reporting date.

The best estimate is normally the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party at reporting date. These estimates are based on judgements by management and these judgements are supported by experience of similar transactions and, in some cases, reports from independent experts. Any events after reporting date should also be considered and included.

Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances, for example:

- Where there is a continuous range possible outcomes, and each point in that range is as likely as the other, then the midpoint of the range is used; alternatively
- Where the provision measured involves a large population, the obligation is estimated by weighting all possible outcomes by the associated probabilities. This statistical method of estimation is referred to as the 'expected value'; and
- For a single item, the most likely outcome is the best estimate.

There are a number of different techniques that can be used to arrive at the best estimate of the amount of the provision, generally entities will base their estimate on either:

- The single most likely outcome; or
- A weighted average of all possible outcomes (the "expected value" method).

Example: Range of possible outcomes

An entity is currently in litigation for allegedly breaching a contract with another entity. The entity is being sued for R1 million for loss in income. The entity's legal advisors assessed the possible outcomes of the case as follows:

- 5% that the lawsuit will fail;
- 10% that an amount of R0.2 million will have to be paid;
- 20% that an amount of R0.5 million will have to be paid;
- 30% that an amount of R0.7 million will have to be paid;
- 35% that an amount of R1 million will have to be paid.

GRAP 19 states that an entity can use a range of possible outcomes, if it is reliable, as the value of the provision to be recognised.

The entity will recognise the most likely outcome based on a range of possible outcomes (determined by the attorneys) calculated as follows:

	R
5% x 0	-
10% x R0.2 million	20 000
20% x R0.5 million	100 000
30% x R0.7 million	210 000
35% x R1 million	350 000
Expected value	**680 000**

Therefore the entity will not recognise the full R1 million, but only the expected value of R680,000. Note that this amount can or will change over time depending on the possible outcomes changing due to new information or events that come to light subsequently.

5.2 Risks and uncertainties

Provisions are always measured under conditions of uncertainty. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision. Caution is needed when making judgements under these conditions, so that revenue and assets are not overstated and expenses or liabilities are not understated. Uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities.

5.3 Present value

If the effect of time value of money is material, the provision should be measured at the present value of the expected future outflows of resources.

The discount rate to be used, to determine the present value, should be pre-tax and should take into consideration the current market assessment of the time value of money as well as risk specifically associated with the liability. The entity should be careful not to adjust the discount rate and the future cash flows for the same risks as this will result in double-counting of risks.

Also refer to ***Example 1: Discount rate***

For the purpose of measuring provisions, cash flows are usually expressed in expected future prices (that is, including inflation) and should, therefore, be discounted using a rate that includes inflation. Alternatively, in certain circumstances where required cash flows have been estimated at current prices it would be appropriate to discount such cash flows using a discount rate that excludes the effect of inflation.

Where discounting is used, the balance of the provision will increase with interest in each period to reflect the passage of time. This is also known as unwinding of the discount. The periodic unwinding of the discount should be treated as a **finance cost in surplus or deficit** as it occurs.

5.4 Future events

Should expected future conditions be taken into account when estimating the amount of the provision?

For example, an entity may believe that the cost of cleaning up a site may be reduced by future changes in technology. The standard indicates that future events that may affect the amount required to settle an obligation should be reflected in the provision, provided there is sufficient objective evidence that they will occur.

Example: Future Events

Using the same information in the Example: Discount rate above.

For which of these scenarios can the future event be taken into account when the provision is measured?

Scenario 1: Entity A expects there will be new technology developed which will decrease the clean-up cost by half.

There is currently no evidence that this technology exists, thus the entity cannot decrease the provision for possible technology developments.

Scenario 2: In year 8, new legislation will be put on the table for approval which will exempt entities from cleaning up gas work sites.

If and when the legislation is approved, the entity will no longer have to make a provision. Just because the process has started to develop, such information is not sufficient evidence that the legislation will be approved. Therefore it will be ignored in measuring the provision.

Scenario 3: During year 5, the entity estimates that, due to their increased experience in cleaning up gas work sites, they can cut the cost to R800,000.

The entity can decrease the provision to R800,000 as evidence suggests that the cost will decrease due to experience gained. The change in the balance of the provision at the beginning of year 5 as a result of the change in the future value - to R800,000, will be accounted for as a change in accounting estimate.

5.5 Expected disposal of assets

Gains from the expected disposal of assets should not be taken into account in measuring a provision even if it is closely linked to the event giving rise to the provision. Instead an entity recognises gains on expected disposals of assets at the time specified by the standards of GRAP dealing with the assets concerned.

Example: Expected gain on disposal

An entity is restructuring its business and the estimated cost of the restructuring is R200 million. Some of the assets of the entity will be sold and a gain of R20 million is expected from the sale of the assets.

The estimated gain on selling of the asset should not be taken into account when measuring the provision for the restructuring. Thus the provision for restructuring should be R200 million and not R180 million (R200m – R20m).

5.6 Future operating deficits

Future operating deficits do not meet the definition of a liability or the recognition criteria of a provision, as no present obligation as a result of past events exist in respect of these losses. Thus a provision should not be recognised for future operating deficits.

An expectation of future operating deficits is an indication that the entity's assets used in these activities might be impaired. These assets should be tested for impairment in accordance with GRAP 21 on *Impairment of Non-cash-generating Assets* and GRAP 26 on *Impairment of Cash-generating Assets.*

6. Changes in Provisions

Provisions should be reviewed at each reporting date and be adjusted to reflect the current best estimate. Should it happen that an outflow of resources or service potential is no longer probable, the provision should be reversed. When reviewing the provision, an entity should consider whether the discount rate (refer to **Example *2*: Decrease in provision due to change in interest rate**) and/or the cash flows (refer to **Example *3*: Decrease in provision due to change in future cash flows**) should be adjusted.

6.1 Rehabilitation provisions

The examples in the previous section provided guidance on the calculation of the rehabilitation provision. This section summarises the accounting requirements.

Decommissioning, Restoration and Similar Liabilities

Measurement: Estimated expenses for decommissioning, restoration etc. consider inflation and discounting;

Initial recognition:

Dr Asset

Cr Provision

Value reflects the extent of damage to be restored or asset to be decommissioned;

Subsequent Measurement of Decommissioning, Restoration and Similar Liabilities

Asset

Depreciate the asset:

Dr Depreciation Expense

Cr Accumulated Depreciation

Liability

Unwind the discount:

Dr Finance Costs

Cr Provision

Revise the provision (change in interest rate, change in cash flows, and change in obligation due to further use of asset)

Dr Asset (if the cost model used) OR

Dr Revaluation surplus/deficit (if the revaluation model is used)

Cr Provision

A decrease in the provision processed against the asset will be limited to the carrying amount of the asset. Any excess should be recognised immediately in surplus or deficit.

In the case of an increase, an entity should consider whether it is an indication that the new carrying amount of the asset may not be fully recoverable. If that is the case, the assets should be tested for impairment in accordance with GRAP 21 on Impairment of *Non-cash-generating Assets* and GRAP 26 on *Impairment of Cash-generating Assets*.

The related asset will be depreciated over its useful life, and in the case of a change in the cost of the asset, will be depreciated over its remaining useful life based on its new carrying amount. Once the asset has reached the end of its useful life, any subsequent changes in the provision should be recognised in surplus or deficit as they occur (this is because the asset's carrying amount is zero).

6.2 Reimbursements

It sometimes happens that when a provision is settled that some or all of the expenditure is to be reimbursed by a third party. The reimbursement should only be recognised, as revenue and a corresponding receivable, when it is virtually certain that the reimbursement will be received.

This reimbursement may not be netted off against the provision but should be disclosed as a separate asset because the entity will remain liable for the full amount should the third party fail to reimburse the entity. The amount recognised for the reimbursements may not exceed the amount of the provision. In the statement of financial performance the expense relating to the provision may be presented net of the amount recognised as a reimbursement.

Should it happen that the entity will not be liable for cost if the third party fails to pay, then neither the provision nor the reimbursement should be recognised by the entity in respect of those costs. Also refer to **Example *4*: Reimbursement costs**

6.3 Use of provisions

A provision should only be used as originally intended. Any unused amounts should be reversed and not be utilised for other purposes. Setting off expenditure against a provision that was originally recognised for another purpose would conceal the impact of two different events.

7. Guarantees

If an entity has issued a financial guarantee to a third party whereby it is required to make payments to the third party in the event that a specified debtor (employee or other person / entity) fails to make payment when due in accordance with the terms of the agreement, it is a financial guarantee contract.

Some entities guarantee the debt of other entities or employees, for example guaranteeing the housing or motor vehicle loans of employees.

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

The obligations (or possible obligations) arising from the issue of financial guarantee contracts are recognised, measured and/or disclosed in accordance with GRAP 19.

Financial guarantee contracts should be derecognised in accordance with GRAP 104 on *Financial Instruments*. As the financial guarantee contracts give rise to certain financial risk exposures to the entity, disclosure should be made as required by GRAP 104.

8. Onerous Contracts

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 exceeds the economic benefits or service potential expected to be received under it.

The unavoidable cost referred to, reflects the net cost of exiting the contract, which is the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it.

Before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred, if any, on assets dedicated to that contract. Guidance for impairment is included in GRAP 21 on *Impairment of Non-cash-generating Assets* and GRAP 26 on *Impairment of Cash-generating Assets*.

If a contract is onerous the present obligation under the contract should be accounted for as a provision.

Example: Onerous contract

On 1 April 20X8, Entity A entered into a lease contract for premises in the Pretoria city centre. The lease is to run for a period of four years (the contract expires on 31 March 20Y2). As a result of several factors, the board decided to relocate to Sandton with effect from 1 April 20x0. The following information is available:

- Operating lease payments payable annually in arrears (with no escalation) R240,000.
- Penalty payable on early cancellation of the contract R250,000.
- Assume a discount rate of 10% and the reporting date is 30 June 20x8.

Entity A has a present obligation due to the signing the contract.

The contract has become onerous as the unavoidable costs of meeting the obligation under the contract (i.e. net cost of exiting the contract) exceeds the economic benefits or service potential expected to be received under it (i.e. zero future economic benefits or service potential are expected as the entity is relocating to another premises).

The provision should be recognised for the unavoidable cost of exiting the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. It is therefore measured as the lower of:

- The present value of future annual payments = R416,529; or
- The penalty payable upon exiting of R250,000.

A provision should therefore be recognised and measured at R250,000.

9. Restructuring

Restructuring is a programme that is planned and controlled by management, and materially changes either:

- The scope of an entity's activities; or
- The manner in which those activities are carried out.

The following events may fall under the definition of restructuring:

- termination of a service line, for example, a call centre;
- close of a branch in a specific region or move of operating activities from one region to another;
- changing the management structure, for example, removing a layer or management; or
- fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

The provision for restructuring cost is only recognised when the general recognition criteria for provisions are met. The definition of a provision requires there to be a past event which gives rise to a legal or a constructive obligation (i.e. present obligation). A constructive obligation for restructuring arises only when an entity:

- Has a detailed plan for the restructuring that identifies at least:
  - The business or part of business concerned;
  - The principal location effected;
  - The location, function and approximate number of employees that will be affected;
  - The expenditure that will be undertaken; and
  - When the plan will be implemented.
- 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.

Should the entity start to implement the plan, announces its main features to those affected, only after reporting date, the restructuring qualifies as a non-adjusting event after reporting date. Refer to GRAP 14 on *Events after the Reporting Date* for more detail.

Example: Restructuring by closing a department/division

On the 31 December 20X7 the board decided to close down the research division. The reporting is 31 March 20X8.

Scenario 1

Before the reporting date, the decision was not communicated to those affected.

At reporting date, no provision will be recognised as there is no obligating event.

Scenario 2

On 2 February 20X8 the board communicated the detailed plan of the restructuring to the staff of the division. Letters were also sent out to customers that the research division will be closed down by 31 July 20X8.

An obligating event occurred when the board communicated the restructuring plan to the employees and the customers. This obligating event gave rise to a constructive obligation. A provision should be recognised at 31 March 20X8 for the best estimate of the cost to close down the division.

If an entity has taken a decision to sell an operation and announced it to the public, a provision cannot be raised if there is no binding arrangement. Without a binding arrangement an entity can still change its mind and if no purchaser is found then they have to take another course of action. Therefore the decision to sell does not meet the requirement of “no realistic alternative of settling the obligation” (they can walk away from it). When a sale is only a part of the restructuring plan, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

A restructuring provision should include only the direct expenditure arising from the restructuring, which are those that are both:

- Necessarily entailed by restructuring; and
- Not associated with the ongoing activities of the entity.

As an example, retaining or relocating continuing staff, marketing or investing in new systems and distribution networks are not included in the cost of restructuring as they relate to the future conduct of the entity’s activities. Onerous contracts due to cancellation of leases, for example, will be included.

Gains on the expected disposal of assets are not taken into account in measuring the restructuring provision, even if the sale is envisaged as part of the restructuring.

10. Contingent Liabilities

A contingent liability is:

- a possible obligation, whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event(s) not wholly within the control of the entity; or
- a present obligation that is not recognised because, the outflow of economic benefits or service potential is not probable; or
- a real present obligation, that may not be recognised, either because the "when" (timing) or because the how much (measurement) is not known.

Contingent liabilities are not recognised as liabilities because they are either:

- possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits or service potential; or
- present obligations that do not meet the recognition criteria of a liability (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

Example: Provision versus contingent liability

A supplier is suing Entity A for breach of contract to the amount of R15 million. The year-end of the entity is 31 March 20X8.

The following two possibilities exist as at 31 March 20X8 in respect of the accounting treatment of the claim:

Option 1: Provision

Should the legal advisers of the entity be of the opinion that the claim will be successful and the amount of R15 million (or any other amount estimated as reasonable by the legal advisers) represents a reasonable estimate of the amount to be paid, the entity recognises a provision for the reasonably estimated amount. A provision is defined as a liability of uncertain timing or amount. In this case uncertainty as to when the amount will be paid exists, but sufficient certainty exists about the fact that there is a liability as well as the approximate amount that would have to be paid.

Option 2: Contingent liability

If the legal advisers are of the opinion that it is merely possible that the claim may be successful, but not probable, the matter will be disclosed as a contingent liability. It will thus not be recognised in the financial statements, but will only be disclosed in the notes to the financial statements. In terms of the definition of a contingent liability, the possible obligation arises from past events (alleged breach of contract) and the existence of an obligation will only be confirmed by the occurrence or non-occurrence of uncertain future events (outcome of claim).

Contingent liabilities should be reviewed continuously to determine if the outflow of resources have become probable. A provision is raised in the financial statements in the period in which the outflow of resources becomes probable.

Example: Change in the probability of the outflow of resources

Entity A terminated the employment of one of its employees. A few months after the termination the employee sued Entity A for unfair dismissal.

At reporting date, 30 June 20X8, the attorneys of Entity A advised that the entity will probably not be held liable.

There were some developments in the case and by the next reporting date the attorneys advised the entity that they will probably be found liable.

Accounting treatment at 30 June 20X8

It is not probable that the entity will be liable thus no provision will be made, however there is a possible obligation due to a past event (dismissal) 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 at 30 June 20X8.

Accounting treatment at 30 June 20X9

At this reporting date it is probable that the entity will be liable and therefore a provision is recognised. The provision will be measured as the best estimate of the amount required to settle the obligation.

Note that the provision recognised at 30 June 20X9 will not be accounted for retrospectively, i.e. by adjusting comparative figures as the circumstances changed (new information came to light) only in the current period.

11. Contingent Assets

A contingent asset is a possible asset that arises from past events, whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events beyond the control of the entity.

A contingent asset should not be recognised but a note disclosure is required if the inflow of resources is probable. Contingent assets are not recognised in the financial statements, because such reflection may lead to the recognition of income that may never realise.

Contingent assets should also be assessed on a continuous basis and should an inflow of resources become virtually certain then the related asset should be recognised.

Example: Contingent asset

The Entity A instituted an action against CTV on 31 January 20X9 for breach of copyright. The court case is currently in progress, and Entity A's lawyers advised them that it is probable, but not virtually certain, that the court will award an amount of R750,000. CTV is a financially sound entity and will be able to pay the R750,000. Entity A's year-end is 31 March 20X9.

At reporting date Entity A will disclose a contingent asset. There is a probable asset (the claimed amount) that arose from a past event (breach of copyright) and whose existence will only be confirmed by the occurrence or non-occurrence of an uncertain future event (outcome of the court case).

12. Executory contracts and disclosures on commitments

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (also known as a commitment).

When a contract is priced on arm's length terms, the initial measurement of that contract would typically be zero, because the rights of one party have the same value as its obligations to the other party. Accordingly, usually neither party recognises a net asset or a net liability at contract inception. After contract inception, one or both parties may need to recognise its asset or liability (for example where one party performs first).

Where the terms are not equivalent to market terms (i.e. not at arm's length), an entity considers whether it has an onerous contract (see **Section 8** on **Onerous Contracts**).

Executory contracts usually require the fulfilment of its terms at a future date or over an agreed period of time. They include numerous forms of arrangements, for example, employment contracts, lease arrangements, service contracts, purchase commitments, and insurance contracts.

Example: Executory contracts

Entity A entered into an agreement with Supplier B on 1 July 20x2 for the purchase of 15 laptop computers. Supplier B is expected to deliver 8 laptops on 15 August 20x2 and the remaining 7 on 1 October 20x2. The price of each laptop was R15,500 (considered to be the fair value on contract date).

1 July 20x2: The entire contract is executory as neither party has performed.

15 August 20x2: Supplier B performed by delivering 8 laptops, and as a result Entity A recognises a liability (payment due to Supplier B for laptops received) of R124,000. The executory part of the contract is now for the delivery of the remaining 7 laptops.

1 October 20x2: On delivery of the remaining 7 laptops the contract is fully executed. There is no longer an executory portion because Supplier B has performed all its obligations. Any amounts owing to Supplier B at that time will be reflected as a liability by Entity A.

Executory contracts (or the commitments in the contracts) are generally not disclosed in the financial statements. A number of GRAP standards however require disclosure, for example:

- GRAP 16 on *Investment Property*: where an entity discloses contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements;

- GRAP 17 on *Property, Plant and Equipment*: where an entity discloses for each class of property, plant and equipment recognised in the financial statements the amount of contractual commitments for the acquisition of property, plant and equipment;
- GRAP 31 on *Intangible Assets*: where an entity discloses the amount of contractual commitments for the acquisition of intangible assets;
- GRAP 103 on *Heritage Assets*: where an entity discloses for each class of heritage assets recognised in the financial statements the amount of contractual commitments for the acquisition, maintenance and restoration of heritage assets; and
- GRAP 13 on *Leases*: where future minimum lease payments under finance and operating leases agreements are disclosed.

These requirements to disclose commitments clearly refer to contractual commitments (i.e. executory contracts) and not to commitments broadly or generally. The requirements in the Standards of GRAP to disclose commitments are therefore only mandatory in respect of commitments that stem from contracts (or agreements in the case of leases) between the parties.

As such, the Standards of GRAP do not require commitments to be disclosed prior to there being a contract (or agreement) in place between the parties involved.

What about internal commitments, such as budget approvals or permissions to procure goods/services?

A commitment is made to another party. It therefore follows that an internal decision by an entity does not give rise to a commitment at the reporting date, unless the decision has been communicated to the other party before the reporting date and as a result a contractual agreement has been established that creates rights and obligations that are legally enforceable. I.e. it must go beyond the entity's powers of recall or withdrawal and must exist independently of the entity's future actions after the reporting date.

Standards of GRAP therefore do not require the disclosure of internally approved commitments, where such internal approvals did not result in a contract (or agreement) with the other party at the reporting date, or only resulted in the parties entering into a contract (or agreement) subsequent to the reporting date.

Some entities that prepare their financial statements in accordance with Standards of GRAP include both "approved and contracted" and "approved but not yet contracted" commitments as part of the "commitment" disclosures in the financial statements. The disclosure of "approved but not yet contracted" commitments is not required by the Standards of GRAP and is likely a legacy issue from earlier versions of the Specimen annual financial statements for national and provincial departments (Specimen financial statements), prepared in terms of the Modified Cash Standard (MCS). The latest version of the Specimen financial statements is in line with the GRAP requirements and no longer requires disclosure of "approved but not yet contracted" commitments.

The standards of GRAP do not define "contract" (or "agreement"). Entities may however consider the application guidance in GRAP 104 on Financial Instruments which clarifies that contracts are evidenced by the following three criteria:

- Contracts involve willing parties entering into an arrangement;
- The terms of the contract creates rights and obligations for the parties to the contract; and those rights and obligations need not result in equal performance by each party. For example, a donor funding arrangement creates an obligation for the donor to transfer resources to the recipient in terms of the agreement concluded, and establishes the right of the recipient to receive those resources. These types of arrangements may be contractual even though the recipient did not provide equal consideration in return, i.e. the arrangement does not result in equal performance by the parties;
- Performance and remedy for non-performance are enforceable by law

13. Grant agreements and accounting for the "return right"

The enforceable rights and obligations applicable to a specific grant arrangement between a grantor and a recipient are set out in a binding arrangement, which will take the form of legislation and/or a contract concluded between the parties (see description of a contract above). The specific rights and obligations applicable in a particular instance will determine the accounting for the grant payments by the grantor (and the recipient), and a careful analysis of these is therefore required in each instance.

Grant arrangements typically fall into two board categories:

- Category 1: Grant arrangements that are:
    - not subject to any requirements regarding how the grant funding must be used, or o subject to requirements that specify that the grant funding must be used for a particular purpose, but that do not contain a requirement that the grant funding must be returned if not used as specified.
- Category 2: Grant arrangements that are subject to requirements that specify that the grant funding must be used for a particular purpose, and that the funding must be returned if not used as specified. (I.e. in the event that the grant requirements are breached, the arrangement calls for the funding to be returned, and therefore gives rise to a "return obligation¨ for the recipient and a "return right¨ for the grantor).

The accounting for category 1 grant arrangements by the grantor is normally straight-forward, as the grantor recognises the grant payment as an expense in the statement of financial performance.

However, for category 2 grant arrangements, where the grant is subject to requirements that the recipient must use the grant funding for a particular (specified) purpose or return the grant funding in the event that the grant requirements are breached, uncertainty may arise about whether and when the grantor should recognise a receivable for the "return right¨.

The GRAP reporting framework does not contain a Standard that specifically deals with the accounting by grantors for grants that are subject to "return rights¨ (non-exchange expenses). Such transactions are outside the scope of GRAP 23, which applies to revenue from non-exchange transactions; i.e. to the accounting by grant recipients. This guidance has been prepared to assist entities with the accounting considerations in the absence of any specific guidance in a standard of GRAP

As indicated above, the grant arrangement between a grantor and recipient will be set out in legislation and/or a contract. In the case of a grant that is subject to a "return right" the grant arrangement will generally take the form of a contract that stipulates all the enforceable rights and obligations between the parties, although it is also possible for the arrangement to be set out in legislation.

- Where the grant arrangement is set out in legislation, the grantor may need to apply the requirements in GRAP 108 on *Statutory Receivables* on whether and when to recognise a receivable for the "return right", as the definition on a statutory receivable may be met.

Statutory receivables are receivables that:

(a) arise from legislation, supporting regulations, or similar means; and

(b) require settlement by another entity in cash or another financial asset.

GRAP 108 then requires the receivable for the "return right" to be recognised when the definition of an asset is met and, when it is probable that the future economic benefits or service potential associated with the asset will flow to the entity and the transaction amount can be measured reliably.

- Where the grant arrangement is set out in a contract, the grantor may need to apply the requirements in GRAP 104 on *Financial Instruments* on whether and when to recognise a receivable for the "return right", as the definitions on a financial instrument and financial asset may be met.

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or a residual interest of another entity.

A financial asset is:

(a) cash;

(b) a residual interest of another entity; or

(c) a contractual right to:

(i) receive cash or another financial asset from another entity; or

(ii) exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.

GRAP 104 then requires the receivable for the "return right" to be recognised when the entity becomes a party to the contractual provisions of the instrument and has an unconditional legal right to the funds.

The underlying principle to keep in mind is whether the receivable for the “return right¨ meets the definition of an asset and the recognition criteria, as well as the timing when the “return right¨ will arise and should be recognised. In particular, consideration may need to be given to, for example the following factors in relation to the timing of when any receivable for a “return right¨ should be recognised:

- When does the grantor have an unconditional right? (GRAP 104.AG79)
- When does the grantor’s presently controlled right to the “return right¨ arise? (Conceptual Framework 5.5 & 5.12)
- When can the grantor enforce the “return right¨? (Conceptual Framework 5.11)
- Whether the grantor ever in the past enforced its “return right¨? (GRAP 23.20)
- When and/or whether the grantor’s “return right¨ will expire or be waived?
- Etc

In assessing when a receivable for the “return right” arises, it is possible that the asset may only arise subsequently in future as a result of, and when or if a breach event occurs or the grantor exercises its “return right”. For example, if an entity is able to at any time demand the return of the funds if the grant requirements are not met, then the “return right” may be a receivable at the outset of the arrangement. However, if the right to a return of the funds is subject to a future event (i.e. the “return right” is dependent on certain future actions/ events), then the “return right” may only be a receivable when the future event occurs.

14. Illustrative Examples

The table below provides further scenarios with an analysis of its impact on the financial statements:

Scenario	Analysis
Contaminated Land – Legislation Virtually Certain To Be Enacted A provincial government owns a warehouse on land near a port. The provincial government has retained ownership of the land because it may require the land for future expansion of its port operations. For the past ten years a group of farmers have leased the property as a storage facility for agricultural chemicals. The national government announces its intention to enact environmental legislation requiring property owners to accept liability for environmental pollution, including the cost of cleaning-up contaminated land. As a result, the provincial government introduces a hazardous chemical policy and begins applying the policy to its activities and properties. At this stage, it becomes apparent that the agricultural chemicals have contaminated the land surrounding the warehouse. The provincial government has no recourse against the farmers or its insurance company for the clean-up costs. At 31 March 20X1, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year end.	**Present obligation as a result of a past obligating event** — The obligating event is the contamination of the land because of the virtual certainty of legislation requiring the clean-up. **An outflow of resources embodying economic benefits or service potential in settlement** — Probable. **Conclusion** — A provision is recognised for the best estimate of the costs of the clean-up
Contamination and constructive obligation An entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy. There is no environmental legislation in place. During the course of a naval exercise a vessel is damaged and leaks a substantial amount of oil. The entity agrees to pay for the costs of the immediate clean-up and the ongoing costs of monitoring and assisting marine animals and birds.	**Present obligation as a result of a past obligating event** — The obligating event is the contamination of the environment, which gives rise to a constructive obligation because the policy and previous conduct of the entity has created a valid expectation that the entity will clean up the contamination. **An outflow of resources embodying economic benefits or service potential in settlement** — Probable. **Conclusion** — A provision is recognised for the best estimate of the costs of the clean-up
Refunds policy A government stores agency operates as a centralised purchasing agency and allows the public to purchase surplus supplies. It has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.	**Present obligation as a result of a past obligating event** — The obligating event is the sale of the supplies, which gives rise to a constructive obligation because the conduct of the agency has created a valid expectation on the part of its customers that the agency will refund purchases. **An outflow of resources embodying economic benefits or service potential in settlement** — Probable that a proportion of goods are returned for refund.

Scenario	Analysis
	Conclusion — A provision is recognised for the best estimate of the costs of refunds
Closure of a division – No implementation before reporting date On 12 March 20X4 government decides to close down a division of a government agency. The decision was not communicated to any of those affected before the reporting date (31 March 20X4) and no other steps were taken to implement the decision.	**Present obligation as a result of a past obligating event** — There has been no obligating event and so there is no obligation. **Conclusion** — No provision is recognised
Outsourcing of a division – implementation before the reporting date On 12 March 20X4, an entity decided to outsource one of its divisions. On 20 March 20X4 a detailed plan for outsourcing the division was agreed by the entity, and redundancy notices were sent to the staff of the division.	**Present obligation as a result of a past obligating event** — The obligating event is the communication of the decision to employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be outsourced. **An outflow of resources embodying economic benefits or service potential in settlement** — Probable. **Conclusion** — A provision is recognised at 31 March 20X4 for the best estimate of the costs of outsourcing the division
Legal requirement to fit air filters Under new legislation, an entity is required to fit new air filters to its public buildings by 30 June 20X5. The entity has not fitted the air filters.	**At the reporting date of 31 March 20X4** **Present obligation as a result of a past obligating event** — There is no obligation because there is no obligating event either for the costs of fitting air filters or for fines under the legislation. **Conclusion** — No provision is recognised for the cost of fitting the filters **At the reporting date of 31 March 20X5** **Present obligation as a result of a past obligating event —** There is still no obligation for the costs of fitting air filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliance of the public buildings). **An outflow of resources embodying economic benefits or service potential in settlement —** Assessment of probability of incurring fines and penalties for non-compliance depends on the details of the legislation and the stringency of the enforcement regime. **Conclusion —** No provision is recognised for the costs of fitting air filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed

Scenario	Analysis
An onerous contract A hospital laundry operates from a building that the hospital (the reporting entity) has leased under an operating lease. During March 20X4, the laundry relocates to a new building. The lease on the old building continues for the next four years: it cannot be cancelled. The hospital has no alternative use for the building and the building cannot be re-let to another user.	**Present obligation as a result of a past obligating event —** The obligating event is the signing of the lease contract, which gives rise to a legal obligation. **An outflow of resources embodying economic benefits or service potential in settlement —** When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the hospital accounts for the lease under the Standard of GRAP on *Leases*). **Conclusion —** A provision is recognised for the best estimate of the unavoidable lease payments
A court case After a luncheon in 20X4, ten people died, possibly as a result of food poisoning from products sold by a restaurant at a public museum (the reporting entity). Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of authorisation of the financial statements for the year to 31 March 20X4 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 March 20X5, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable.	**At 31 March 20X4** **Present obligation as a result of a past obligating event —** On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events. **Conclusion —** No provision is recognised by the museum **At 31 March 20X5** **Present obligation as a result of a past obligating event —** On the basis of the evidence available, there is a present obligation. **An outflow of resources embodying economic benefits or service potential in settlement —** Probable. **Conclusion —** A provision is recognised for the best estimate of the amount to settle the obligation
Refurbishment costs – No legislative requirement A furnace for heating a building that is leased out by a government department to a number of public sector tenants has a lining that needs to be replaced every five years for technical reasons. At the reporting date, the lining has been in use for three years.	**Present obligation as a result of a past obligating event —** There is no present obligation. **Conclusion —** No provision is recognised The cost of replacing the lining is not recognised because, at the reporting date, no obligation to replace the lining exists independently of the entity's future actions — even the intention to incur the expenditure depends on the entity deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, that is, it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.
Refurbishment costs – Legislative requirement A government cartography service is required by law to overhaul its aircraft used for aerial mapping once every three years.	**Present obligation as a result of a past obligating event —** There is no present obligation. **Conclusion —** No provision is recognised The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in

Scenario	Analysis
	the example above. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions — the entity could avoid the future expenditure by its future actions, for example by selling the aircraft.

Example 1: Discount rate

Entity A has to clean-up a gas work site after 10 years. The expected cost for this in year 10 is R1,000,000. Assume for simplicity that from day one (the beginning of Year 1), the entity uses the entire site and is accordingly obligated to clean-up the whole area from that date.

In determining the discount rate, the entity needs to determine what type of risk is associated with the future cash flows. Factors to take into account would be for example:

- How will the cash flows be obtained;
- Will the entity be able to maintain the inflow of cash to pay for the expenses?

Note that the expected cost of R1,000,000 is the cost expected in year 10 (i.e. the future value), thus the cash flows have already been adjusted for time value of money and the discount rate does not need to be adjusted for time value of money again.

After taking all factors into consideration Entity A calculated the discount rate at 11.25%.

The provision (i.e. present value) will be calculated as follows:

FV = -R1,000,000

PMT = nil

i = 11.25 %

N = 10 years

i.e. PV = R344,350. This can be calculated by using MS Excel or a financial calculator.

Example 2: Decrease in provision due to change in interest rate

Using the same information as in ***Example 1: Discount rate***, the provision is initially recognised at R344,350 and increases annually with the unwinding of the discount. Assume at the end of year 3 the discount rate changes to 12.5 %.

	Net present value (at rate of 11.25%)	Borrowing costs (at rate of 11.25%)	Net present value (at rate of 12.5%)	Borrowing costs (at rate of 12.5%)
	R344,350			
Year 1	R383,089	R38,739		
Year 2	R426,187	R43,098		
Year 3	R474,133	R47,946	R438,462	
Year 4			R493,270	R54,808
Year 5			R554,929	R61,659
Year 6			R624,295	R69,366
Year 7			R702,332	R78,037
Year 8			R790,123	R87,791
Year 9			R888,889	R98765
Year 10			R1,000,00	R111,111

The journal entry to account for the provision in year 1 will be as follows:

Year 1	Debit	Credit
	R	R
Gas work site (asset)	344,350	
Provision for clean-up costs		344,350
Recognising present value of provision for clean-up costs against the related asset		

The standard requires an entity to recognise any increase in the provision as a result of the unwinding of discount as finance cost in surplus or deficit.

The journal entry to account for the unwinding of discount to the end of Year 1:

End of Year 1	Debit	Credit
	R	R
Finance cost (surplus or deficit)	38,739	
Provision for clean-up costs (R344, 350 x 11.25%)		38,739
Recognising the increase in provision due to unwinding of discount		

The total value of the provision at the **end of Year 1** is R383,089, which can also be calculated as follows:

FV = -R1,000,000

PMT = nil

i = 11.25 %

N = **9 years (from the reporting date)**

i.e. PV = R383,089

At the next reporting date, it is estimated that the clean-up will still cost R1,000,000. The only adjustment to the provision will therefore be the interest due to the unwinding of discount.

The journal entry to account for the unwinding of discount in year 2 will be as follows:

End of Year 2	Debit	Credit
	R	R
Finance cost (surplus or deficit)	43,098	
Provision for clean-up costs (see table above)		43,098
Recognising the increase in provision due to unwinding of discount		

The obligation at the beginning of Year 3 (measured at 11,25 %) is R426,187 and at the end of year 3 it would have been R474,133 if the rate remained unchanged. However, based on the current rate of 12.5% the estimated net present value at the end of year 3 needs to be R438,462.

The difference of R12,275 (R438,462 – R426,187) is made up of a finance cost (for the unwinding of the discount) and a change in estimate of the provision (due to the change in discount rate).

Opening balance of provision	**R426,187**	
Increase in provision arising from passage of time (unwinding of discount) *Calculated at the rate during the year*	R47,946	Net difference of R12,275
Decrease in provision resulting a change in the discount rate *Change in discount rate at the end of year*	(35,671)	
Closing balance of provision	**R438,462**	

IGRAP 2 – Changes in Existing Decommissioning, Restoration and Similar Liabilities, requires an entity to add a change to (i.e. provision increased) or deduct a change from (i.e. provision decreased) the cost of the related asset (e.g. landfill site, etc.).

The journal entries at the end of Year 3 are as follows:

End of Year 3	Debit	Credit
	R	R
Finance cost (surplus or deficit)	47,946	
Provision for clean-up costs (see calculations above)		47,946
Recognising the increase in provision due to unwinding of discount		

End of Year 3	Debit	Credit
	R	R
Provision for clean-up costs	35,671	
Gas work site (asset)		35,671
Recognising the decrease in provision due change in discount rate		

Example 3: Decrease in provision due to change in future cash flows

Assume the same information as in ***Example 2: Decrease in provision due to change in interest rate***, however at the beginning of Year 5 the entity estimates that, due to their increased experience in cleaning up gas work sites, they can cut the costs to R800,000.

With the original R1,000,000 provision, the balance at the end of year 4 would have been R493,270. With the new estimate or R800,000, the present value will be as follows (remember the change in estimate was at the beginning of year 5 and thus there are still 6 years remaining):

FV = -R800,000

PMT = nil

i = 12.5 %

N = 6 years

i.e. PV = R394,616. This can be calculated by using MS Excel or a financial calculator.

	Net present value (at rate of 11.25%)	Borrowing costs (at rate of 11.25%)	NPV (at rate of 12.5%)	NPV (at rate of 12.5%) Change in cash flows	Borrowing costs (at rate of 12.5%)
	R344,350				
Year 1	R383,089	R38,739			
Year 2	R426,187	R43,098			
Year 3	R474,133	R47,946	R438,462		
Year 4			R493,270	R394,616	
Year 5				R443,943	R49,327
Year 6				R499,436	R55,493
Year 7				R561,866	R62,430
Year 8				R632,099	R70,233
Year 9				R711,111	R79,012
Year 10				R800,000	R88,889

The movement in the provision is calculated as follows:

Opening balance of provision	**R493,270**
Increase in provision arising from passage of time (unwinding of discount)	R49,327
Decrease in provision resulting a change in cash flows (R394,616 – R493,270)	(R98,654)
Closing balance of provision	**R443,943**

The journal entries at the end of Year 5 are as follows:

End of Year 3	Debit	Credit
	R	R
Finance cost (surplus or deficit)	49,327	
Provision for clean-up costs (see calculations above)		49,327
Recognising the increase in provision due to unwinding of discount		

End of Year 3	Debit	Credit
	R	R
Provision for clean-up costs	98,654	
Gas work site (asset)		98,654
Recognising the decrease in provision due change in discount rate		

Example 4: Reimbursement costs

The entity has a legal obligation of R100,000 to an individual for damages caused as a result of misleading advice provided by its employees. The entity will be able to recover 80% from professional indemnity insurance. The reporting date is 31 March 20x0.

The entity should raise a provision for R100,000 as they have a present obligation as a result of a past event. Should the entity be virtually certain that they can recover the 80% from insurance, then an asset should be recognised for R80,000 (R100,000 x 80%).

The disclosure would be as follows:

Extract from Statement of Financial Position	20x0	20y9
	R	**R**
Current assets		
Receivables from exchange transactions	80,000	XX
Current liabilities		
Provisions	(100,000)	XX

Extract from Statement of Financial Performance	20X0	20Y9
	R	**R**
Expenses		
General expenses (R100,000-R80,000)	20,000	XX

If the entity is not virtually certain that they will receive R80,000 from insurance, but it is probable, then a contingent asset should be disclosed and not an asset recognised, and the expense raised for R100,000.

15. Useful links and references

Reference	Location of reference
Frequently Asked Questions (**FAQs**) on the Standards of GRAP	ASB website: http://www.asb.co.za/frequently-asked-questions/
IGRAP 2 on *Changes in Existing Decommissioning, Restoration and Similar Liabilities*	ASB website: http://www.asb.co.za/interpretations-approved-and-effective/
IGRAP 4 on *Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*	
IGRAP 6 on *Loyalty Programmes*	
IGRAP 7 on *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*	
IGRAP 8 on *Agreements for the Construction of Assets from Exchange Transactions*	
IGRAP 14 on *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*	
IGRAP 17 on *SCA where Grantor Controls Significant Residual Interest*	
IGRAP 19 on *Liabilities to Pay Levies*	
Guideline on The Application of Materiality to Financial Statements	ASB website: http://www.asb.co.za/guidelines/
Guideline on Accounting for Landfill Sites 2019	
Standard Chart of Accounts for Local Government (**mSCOA**)	National Treasury website: http://mfma.treasury.gov.za (mSCOA – Municipal Standard Chart of Accounts)
Illustrative Financial Statements for local government	National Treasury website: http://mfma.treasury.gov.za (mSCOA – Municipal Standard Chart of Accounts)