

TECHNICAL NOTE
PROVISIONS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES
IAS 37

1. Background.

The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient supplementary information is disclosed in the notes to the financial statements to enable users to understand the nature, maturity schedule and amounts of the above items.

This IAS is not applicable in the case of:

- Assets or liabilities arising from financial instruments carried at fair value for accounting purposes,
- Contracts pending fulfillment, except if the agreement is onerous and losses are contemplated.

A contract is onerous when the unavoidable costs of meeting the contractual obligation exceed its expected economic benefits.

A contract pending fulfillment is that in which the parties have not fulfilled any of the obligations to which they are committed or in which these have been fulfilled partly and to the same extent.

- Those appearing in the insurance companies, derived from the policies of the insureds.
- Those not addressed by any other International Accounting Standard, such as IAS 11 "Construction Contracts", IAS 12 "Tax on Profits", IAS 17 "Leases", IAS 19 "Benefits to Employees", IFRS 3 "Business Combinations" and IFRS 4 "Insurance Contracts".

Therefore, in the presence of an onerous contract, these obligations derived therefrom must be recognized and measured as provisions in the financial statements.

A provision for restructuring costs must also be recognized for the disbursements directly arising from the same, only in those cases where:

- The entity has a detailed formal plan for restructuring,
- A valid expectation has been given to those affected that the restructuring will be carried out either because the plan has started to be implemented or because its main features have been announced.

2. Summary of IAS 37

2.1. Provision

i. Definitions

Provision: It is a liability involving uncertainty about its amount or maturity.

In some countries the term “provision” is used to refer to the recognition of a loss attributable to the impaired value of some assets, such as doubtful accounts, or due to the recording of a depreciation in a systematic manner. This standard does not refer to this particular concept.

Each provision must be used only for expenditures for which it was originally recognized.

Liability: It is a present obligation arising from past events, at the maturity of which and to settle it, the entity expects to part with resources embodying economic benefits.

In line with the foregoing, provisions differ from other liabilities, even from those subject to estimation, because there is uncertainty about the timing or amount of future expenditure needed to settle them.

Unlike provisions, liabilities with commercial creditors are accounts payable for goods or services that have been received and invoiced or for which there is a formal agreement with the supplier, whereas accrued obligations are accounts payable that have not been paid, invoiced or formally agreed with the supplier, such as obligations with the employees for vacations accrued and not taken by year end. Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is much less than for provisions.

ii. When should a provision be recognized?

A provision should be recognized when and only when each and every one of the following three conditions are met:

- The entity has a present obligation (legal or constructive), as a result of a past event.
- It is probable that it will be required for the entity to allocate resources embodying economic benefits to settle the obligation.
- A reliable estimate can be made of the amount of the relevant debt.

A *legal obligation* arises from a contract, legislation or other legal cause, whereas a *constructive obligation* is that derived from the actions of the entity itself, where because of an established pattern of past practice, entrepreneurial policies that are public knowledge or a declaration made, the entity has indicated to third parties that it is willing to accept a certain type of responsibilities and, as a result of the foregoing, the

entity has created a valid expectation on the part of those third parties with whom it must fulfill its commitments or responsibilities.

A past event gives rise to a present obligation if as a result thereof the entity has no realistic alternative to paying the obligation created by said event. In most of the cases it is clear whether a past event created a present obligation.

Since there must be a past event giving rise to a present obligation, *it is not possible to recognize provisions for expenses that need to be incurred to operate in the future. Thus, provisions will be recognized only for obligations arising from past events existing independently of the entity's future actions.*

Therefore, *provisions shall not be recognized for future operating losses*, since these do not meet the definition of a liability or the general recognition criteria set out for provisions. In any case, the standard considers that the expectation of future operating losses, derived from ordinary activities, may be an indication that certain assets of the operation may be impaired and the entity must test said assets for impairment under IAS 36 "Impairment of Assets".

Except in extremely rare cases, the entity will be able to determine a range of possible outcomes for the uncertain situation and may, therefore, make an estimate of the amount of the obligation that is sufficiently reliable to use in recognizing the provision.

Only in some rare cases, for example in a lawsuit, it may not be clear whether a present obligation exists or what the estimated amount thereof is. In case of doubt, all available evidence should be taken into account, including expert opinion, as well as the facts subsequent to the closing and, based on this, it should be established whether it is more likely than not that a present obligation exists at the balance sheet date. Depending on the results of such evidence, it shall:

- Recognize a provision
- Disclose a contingent liability in notes to financial statements.

iii. Measurement

The amount recognized as a provision should be the best estimate, at the balance sheet date, of the expenditure required to settle the present obligation. In order to obtain the best estimate possible, the risks and uncertainties surrounding the event that gave rise to the provision must be taken into account.

For these purposes, it is necessary to analyze all possible resulting scenarios and their financial effect, based on the judgment of the management, the experience in similar transactions, reports from experts and even facts occurring after the closing of the financial statements. Probable future events that may affect the amount required to settle the obligation shall also be taken into account, provided there is sufficient objective evidence that they will indeed occur.

Where the entity expects that some or all of the expenditure required to settle the provision is reimbursed to it by a third party, the reimbursement shall be recognized when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation subject to the provision.

In the event of a material financial effect resulting from the discount of a future expenditure, the amount considered to record the provision should be the present value of the expenditure expected to make in order to settle the obligation.

The discount rate to be used must be a pre-tax rate that takes into account the market evaluations corresponding to the time value of money at the balance sheet date, as well as the specific risk of the relevant liability.

Once the provision is recognized, it should be reviewed at each balance sheet date and adjusted, if necessary, to reflect the best estimate then existing.

iv. Information to be Disclosed

For each type of provision, the entity must disclose:

- Book value at the beginning and at the end of the period.
- Allowances made during the period, also including increases on the existing provisions.
- Amounts used in the course of the period.
- Unused amounts reversed or settled during the period
- Increase during the period in balances subject to discount

In this case, it is not required to provide comparative information.

The following should also be disclosed:

- A brief description of the nature of the incurred obligation and the expected timing of any resulting outflows of economic benefits.
- An indication of the uncertainties about the amount or timing of those outflows.
- The amount of any expected reimbursement.

Where it is not possible to disclose the required information, this fact must be disclosed in the relevant notes.

2.2. Contingent Assets and Liabilities

i. Definitions

Contingent Liability. A contingent liability is:

- A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- A present obligation that arises from past events but is not recognized because:
 - It is not probable that an outflow of resources embodying economic benefits will be required from the entity to settle the obligation; or
 - A sufficiently reliable estimate of the amount of the obligation cannot be made.

Contingent Asset. A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

The term “contingent” refers to assets and liabilities that have not been recognized in the financial statements, because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

ii. When should a contingent asset or liability be recognized?

An entity should not recognize contingent assets or contingent liabilities.

However, the existence of a contingent liability should be reported in notes to the financial statements, unless the probability of any outflow is regarded as remote. These liabilities may evolve in a manner different from what was initially expected and, therefore, they should be subject to constant reconsideration.

Contingent assets usually arise from unexpected or unplanned events that give rise to the possibility of an inflow of economic benefits to the entity. Contingent assets should not be recognized in financial statements since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not of a contingent nature.

Information should be disclosed in notes to the financial statements about contingent assets and these should be subject to constant revision.

iii. Information to be disclosed.

Unless the possibility of any outflow in settlement is remote, the entity should give, for each class of contingent liability at the balance sheet date, a brief description of the nature of the contingent liability and, where practicable:

- An estimate of its financial effects.
- An indication of the uncertainties about the amount or timing of those outflows.
- The possibility of any reimbursement

Where an inflow of economic benefits is probable, the entity must include in the notes to financial statements a brief description of the nature of the relevant contingent assets existing at the balance sheet date and, when possible, an estimate of their financial effects.

In some cases, extremely rare in practice, disclosure of the information to be disclosed related to the required items can be expected to seriously prejudice the position of the entity in disputes with other parties on the subject matter of the provisions, the contingent liabilities or the assets of like nature. In such cases, the entity need not disclose this information, but should disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.

3. IAS Analysis

The following is a summary of the considerations presented in three articles on the subject:

- Provisions in Central Banks – Banco de España
- Improving financial reporting – Jeremy Foster
- Profit and Loss, dividends and capital. Considerations for Central Banks - Kenneth Sullivan¹

The document prepared on behalf of Banco de España: *“Provisions in Central Banks”* by Francisco Oviedo Pro, in order to contribute to the conclusions of the IX Meeting of the Committee on Accounting and Budget Aspects for Central Banks of Latin America and the Caribbean, presents an extensive exposition of the risks faced by a Central Bank and that IFRS 37 fails to consider.

Some of the most important risks are: “interest rate market risk”, “exchange rate market risk” and “gold price market risk”.

In the particular case of the exchange rate market risk, an analysis is made of the possibility that a Central Bank cannot or does not consider convenient, within the framework of the objectives it must fulfill, to hedge against said risk by using the ideal financial instruments for said purpose.

¹ Published in the book “Accounting Standards for Central Banks” Edited by Neil Courtis and Benedict Mander

According to the above-mentioned paper, Central Banks would have no alternatives other than:

- Controlling the level of the items that may produce negative results and adapt them to the particular circumstances.
- Calculating revaluation reserves, which contravenes the provisions in IFRS 21 "Effects of changes in foreign exchange rates". This same situation would occur in the case of securities to be traded, in accordance with the provisions in IFRS 39 "Financial Instruments: Recognition".
- Recording provisions for future risks, which, as seen in subparagraph 2 of this report, contravenes the provisions in IFRS 37.
- Creating reserves to cover against these risks or a mechanism for the State to reimburse to the Central Bank for the losses attributable to this item. In this case, it is considered that this is not normally contemplated in the Charters of Central Banks.

In summary, this paper proposes that if a Central Bank's Charter establishes the level of profits that should be distributed to the State, without allowing it to create reserves to cover the aforesaid risks, its equity will become impaired and, thus, it will lose the independence required to fulfill its objectives.

As proposed by Jeremy Foster in his paper "Improving financial reporting", the Central Bank is one of the few institutions related to the Government in all countries that is obliged to publish a formal financial report of its activities, which is a source of significant interest. However, the information provided is often intermingled with the Government's accounts, as a way to fulfill the requirements of domestic policy instead of meeting the needs of international users.

The IFRS application establishes an important reference framework as a way to provide transparency in financial reports, as recommended by the IMF. However, the special operating interaction of the Central Bank with its main shareholder, the Government, entails numerous difficulties that cannot be resolved within the framework of the IFRS. The structure and organization of debt management, supervision and monetary policies vary widely from country to country. The Central Bank is usually an agency autonomous from the Government, responsible for reserve management operations, which cannot be properly understood without making any form of consolidation of the accounts of the Government to measure results within a broader context of budgetary strategy and macroeconomic policies. Derivatives, tax duties and contingent liabilities associated to this interaction with the Government are often difficult to identify completely and even more difficult to be appropriately measured. The challenge is to find an accounting framework for reporting relevant information, both internal and external, without duplicating efforts and without introducing confusion about the different basis of preparation.

The classification of assets and financial instruments, measurement on the basis of amortized cost or actual value under IFRS 39 and the treatment of unrealized profits and losses according to IFRS results in an increased volatility of revenues.

A Central Bank can see increased volatility in its results by fulfilling the provisions of IFRS 21 and 39 and an imbalance can occur between the recognized results and those effectively realized, which has an impact on the distribution of profits and losses.

The inclusion of unrealized profits on foreign currency holdings, which are exceedingly volatile, may lead to distributing unreal profits for the Government. Therefore, there is a tendency to transfer said unrealized profits to a reserve before calculating the amount of available profits to be distributed.

Jeremy Foster concludes that if Central Banks as a whole consider that the full adoption of the IFRS is not the correct answer for them, then the development of a specific accounting and reporting framework for Central Banks is an objective that they should attain.

A study conducted by Kenneth Sullivan on “Profits, dividends and capital – considerations for Central Banks” proposes that as a condition for a broader independence of Central Banks, these have improved their transparency and the recording of their transactions. However, it is crucial to establish a clear dividend distribution policy in order to ensure an adequate level of capital and, therefore, financial independence.

Ideally, a Central Bank should have sufficient capital to absorb losses that may arise from the fulfillment of its duties and still maintain a positive capital position. The capital of a Central Bank is derived from three sources: authorized capital, retained earnings and revaluation reserves. The main revenues of a Central Bank arise from its own duties regarding currency issuance, monetary policy and stability of the financial system. The management of international reserves is another legitimate function of a Central Bank.

Of these functions, the most profitable are the issue of circulating currency and the existence of the commercial banks' unremunerated bank reserves. Also, the performance of duties that include monetary policy operations and management of foreign exchange reserves provides a major source of earnings from interest. On the other hand, the main expenses are interest, chiefly derived from the implementation of the monetary policy.

The most unpredictable results arise from the exchange rate differences of foreign currencies and from the costs of the financial system crises, which involve the provision of liquidity to banks in difficulties. This is not a generalized situation, since there are Central Banks that are in a position to hedge the risk of their exchange rate positions or which have fully guaranteed coverage against the risk of failures in the financial system.

In the absence of specific accounting standards for Central Banks, the latter started to gain transparency by adopting the international standards applicable to commercial

financial entities. Although it is recognized that it is quite difficult to adapt to the IFRS, assuming the latter is an argument in favor of the credibility and transparency of these institutions. However, there are remarkable exceptions to their application, for example, the European Central Bank, which defers recognition of exchange profits during measurement until their realization, and the U.S. Federal Reserve, which reports its values at amortized cost instead of actual value. In both cases, the result of their policies is the exclusion of unrealized revaluation profits from the measurement of profit.

In this context, the International Accounting Standards Committee states that it is not appropriate to stop recognizing profits until these are realized, in order to reduce the amount of distributable profits. It is fundamental, instead, to separate the dividend distribution policy from the measurement of profits.

It is inappropriate to use accounting policies to distribute dividends. As the independence of a Central Bank requires, at least, a non-negative capital, the dividend policy needs to balance the maintenance of an appropriate capital and reserves with the Government's legitimate expectation of profit distribution.

The unique nature of Central Banks causes the divergence between profits and distributable dividends to be wider than in commercial entities. Most of the profits may be unrealized and the distribution of profits, when the Central Bank lacks liquid assets, may generate adverse effects on the monetary policy and the economic conditions.

As the revaluation of foreign currencies usually accounts for the most important unrealized profits and losses, an alternative is to transfer these unrealized profits to a revaluation reserve before determining distributable dividends.

In the event of losses resulting in a negative capital, the Central Bank needs to seek recapitalization from the Government or coverage of losses.

Jeremy Foster concludes that the adoption of the IFRS to achieve transparency and credibility, including measurement at actual value, has resulted in a higher volatility of profits with an increase in unrealized profits. This has caused the distribution of dividends and reserves to be a problematic point to ensure the maintenance of the Central Bank's capital. Therefore, it is necessary to separate the measurement criteria from the results of the Government's dividend distribution policies, so as to maintain a risk-based non-negative capital, through the maintenance of sufficient reserves to be protected against losses. At the same time, banks need to address the Government's legitimate rights to the distribution of profits, without impairing monetary policy efficacy. Dividends should be of a residual nature, after the creation of sufficient reserves that enable to cover any future risks the Bank may face.

4. Alternative proposal.

As a way to reconcile the need to maintain an adequate level of capital and reserves, without distributing unrealized profits, while recognizing and reporting their results with the necessary transparency and credibility through their Statement of Profit and Loss, according to internationally recognized accounting standards, it is proposed that

the alternative method of achieving this objective through the profit distribution process be followed.

In this respect, it is considered appropriate for Central Banks to measure their profits according to the IFRS and then proceed to create a reserve with unrealized profits derived from the application of IFRS 21, before determining distributable profit. It would be desirable that the rules governing Central Banks (Charts, By-laws, etc.) incorporate profit distribution criteria in accordance with the above-mentioned points.

In this way, the measurement of profits would be separated from their distribution process.

5. Conclusions.

The application of the IFRS should not prevent a Central Bank from having an adequate capital to fulfill its specific functions.

In their position as foreign currency manager, Central Banks are exposed to risks derived from the variation in the exchange rates of foreign currencies. These unrealized profits are extremely volatile and, therefore, must be hedged through suitable accounting reserves.

Profits can be calculated as established by the IFRS, by allocating both realized and unrealized profits; thereby complying with the adequate accounting framework in reporting the statement of profit and loss for a period. However, to fulfill the purpose of maintaining a risk-based non-negative capital, a dividend distribution policy should be defined to allow, in principle, for the creation of the reserves that may be considered necessary and, then, to distribute the remainder to the Government. The criteria to carry out profit distribution should be incorporated into the charts governing the operation of Central Banks.