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FINANCIAL ACCOUNTING II



UNDERGRADUATE COURSES:
MANAGEMENT, ECONOMICS AND
FINANCE

2024/2025
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SYLLABUS



2) IFRS

Accounting Harmonization
Standards: IAS 1, IAS 2, IAS 16, IAS 36, IAS 37 & IAS 38

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Accounting Harmonization

Readings: Chapters 1 (7), 5

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Financial reporting standards

Each country has developed its own series of “standards” (local generally accepted accounting principles or “local GAAP”) →

Objective: comparability within a country

In Portugal, the CNC (Comissão de Normalização Contabilística) issues the financial reporting standards that determine how specific types of transactions and events are to be reflected in financial statements

The development of international trade, multinational companies and the globalization of financial markets →

Accounting Harmonization → Objective: comparability of financial statements of companies in different countries

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The International Accounting Standards Board (IASB)



Established in 2001, the IASB is the standard-setting body (independent, private sector regulatory body) of the IFRS Foundation

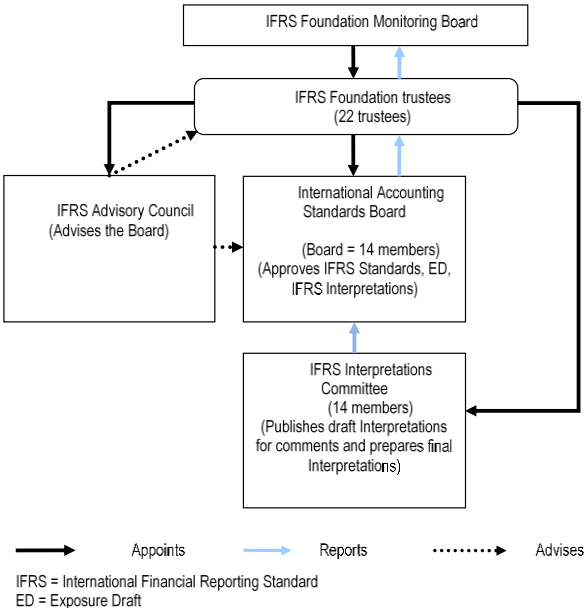
The IASB’s main objective is to promote convergence of accounting principles and practices to be used by organizations for financial reporting around the world

The goal is to develop a single set of high-quality accounting standards, to promote the rigorous application of those standards and to promote and facilitate the adoption of the IFRS Standards

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IASB’s structure



Source: Figure 5.1 from
Stolowy, Ding & Paugam
(2024)

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IASB – Accounting standards

Framework for the Preparation and Presentation of Financial Statements (Conceptual Framework)

International Financial Reporting Standards and International Accounting Standards (IAS and IFRS)

Interpretations of International Accounting Standards (IFRIC and SIC)

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Conceptual framework

The objective of general purpose financial reporting
Qualitative characteristics of useful financial information
Financial statements
The elements of financial statements
Recognition and Derecognition
Measurement
Presentation and disclosure
Concepts of capital and capital maintenance

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The objective of general purpose financial reporting



Objective: to inform existing and potential investors, lenders and other creditors about the entity's economics resources, claims against the entity, and changes in those economic resources and claims

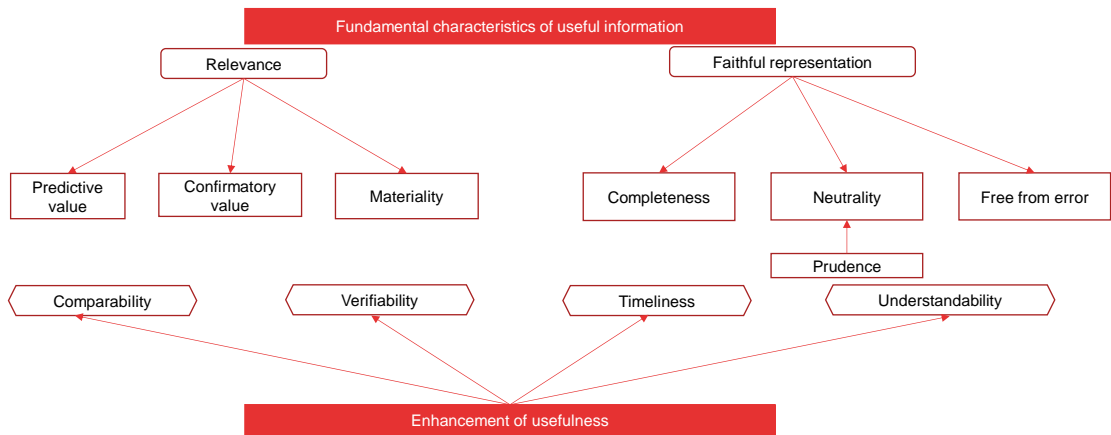


Financial position, economic performance, cash flows

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Qualitative characteristics of useful financial statements (IASB, C. Framework §2.1)



Source: Fig. 1.5 from Stolowy, Ding & Paugam (2024)

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Elements of financial statements (IASB, C. Framework Table 4.1)



Recognition
Derecognition
Measurement

Table 4.1—The elements of financial statements

Item discussed in Chapter 1	Element	Definition or description
Economic resource	Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
	Liability	A present obligation of the entity to transfer an economic resource as a result of past events.
Claim	Equity	The residual interest in the assets of the entity after deducting all its liabilities.
	Income	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
Changes in economic resources and claims, reflecting financial performance	Expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.
	—	Contributions from holders of equity claims, and distributions to them.
Other changes in economic resources and claims	—	Exchanges of assets or liabilities that do not result in increases or decreases in equity.
	—	

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IAS 1 – Presentation of Financial Statements

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General features

Fair presentation and compliance with IFRSs

Going concern

Accrual basis of accounting

Materiality and aggregation

Offsetting

Frequency of reporting

Comparative information

Consistency of presentation

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Financial statements

Statement of Financial Position (or Balance Sheet) at the end of the period

Income Statement (or Statement of Profit or Loss) for the period

Statement of Cash Flows (or Cash Flow Statement) for the period

Statement of Changes in Equity for the period

Notes, including accounting policies and other information

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Statement of financial position

IAS 1 indicates line items to be presented

Additional line items should be included when considered relevant

Subclassifications of the line items presented (according to requirements of IFRSs) shall be disclosed either in the statement of financial position or in the notes → Example: IAS 16 requires PPE is disaggregated into classes

Current / non-current distinction for assets and liabilities

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Current assets

An entity expects to realize the asset within 12 months after the reporting period **or**

An entity expects to realize the asset, sell or consume it in its normal operating cycle **or**

The asset is held primarily for the purpose of trading **or**

The asset is cash or cash equivalent (IAS 7), unless its use is restricted

All other assets are to be classified as non-current

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Current liabilities

- An entity expects to settle the liability within 12 months after the reporting period **or**
- An entity expects to settle the liability in its normal operating cycle **or**
- The liability is held primarily for the purpose of trading **or**
- It does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period

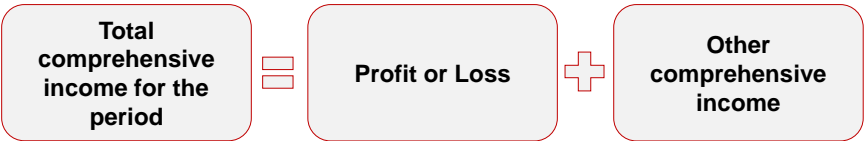
All other liabilities are to be classified as non-current

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Statement of profit or loss and other comprehensive income



Total comprehensive income is the change in equity during a period resulting from transactions and other events, that are not changes resulting from transactions with owners in their capacity of owners

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Statement of profit or loss and other comprehensive income - Presentation

Two alternative ways:

A single statement of profit or loss and other comprehensive income, with two sections: Profit and Loss, and Other Comprehensive Income

Two separate statements, one for profit or loss and another for other comprehensive income, where:

- Profit or loss statement showing items of income and expense and the profit or loss for the period
- Other comprehensive income statement, beginning with profit or loss and afterwards showing items of other comprehensive income, total other comprehensive income and total comprehensive income for the period

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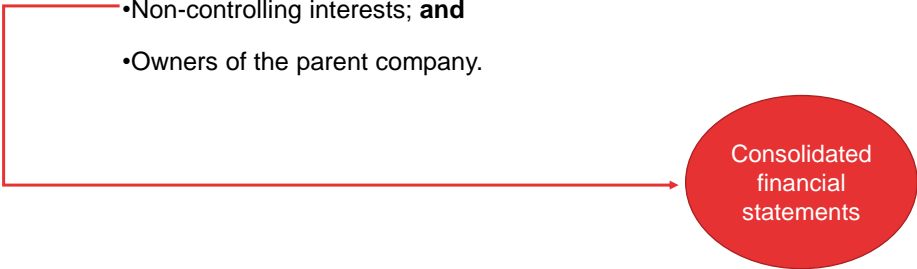
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Statement of profit or loss and other comprehensive income – Presentation (cont.)

Allocation of profit or loss and other comprehensive income for the period:

- Non-controlling interests; **and**
- Owners of the parent company.



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Profit or loss - Presentation

Expenses may be presented according to:

- Nature

Function
- Reliability and Relevance

In case expenses are reported by function, disclosure of information on the nature of expenses is needed since it is useful in predicting future cash flows.

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Other comprehensive income - Presentation

Items classified by those that:

- Will not be reclassified subsequently to profit or loss; **and**
- Will be reclassified subsequently to profit or loss when certain conditions are met.

Items may be presented:

- Net of related tax effects; **or**
- Before related tax effects, showing aggregate amount of income tax.

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Statement of changes in equity - Presentation



Total comprehensive income for the period, showing separately the amounts attributable to the non-controlling interests and to the owners of the parent company

For each equity component, the effects of retrospective application / restatement (IAS 8)

For each equity component, reconciliation of beginning and ending amounts, disclosing changes in profit or loss, other comprehensive income and transactions with owners in their capacity of owners

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Statement of cash flows - Presentation



IAS 7 – Statement of Cash Flows

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Notes - Presentation

Present information on the basis of preparation of financial statements and accounting policies and sources of estimation uncertainty

Disclose information required by the IFRSs and not presented elsewhere

Provide additional relevant information to understanding financial statements

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Notes - Presentation

Declaration of compliance with IFRSs

Presented in a systematic manner

Cross-reference items in the other financial statements

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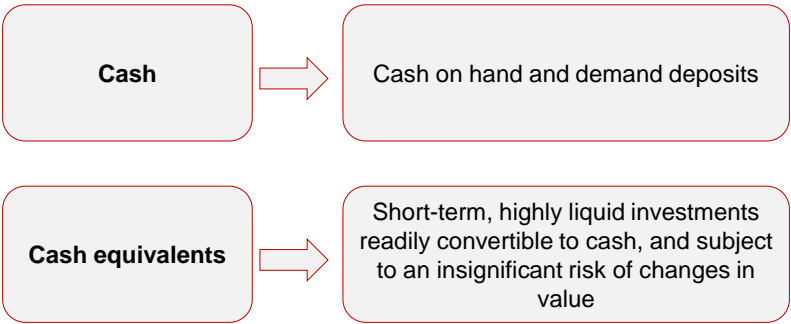
IAS 7 – Statement of Cash Flows

Readings: Chapter 16

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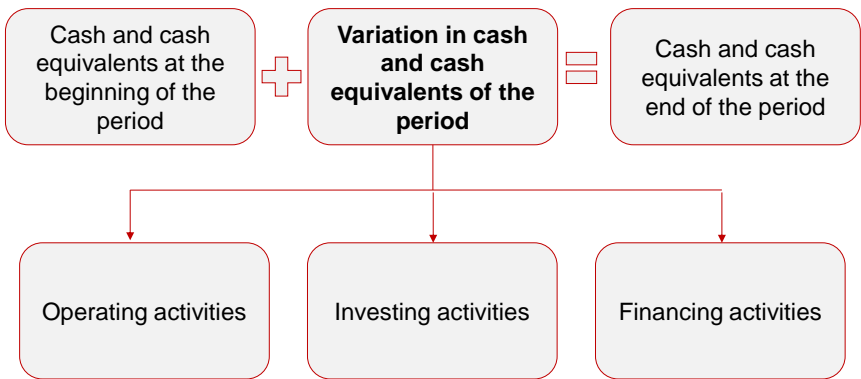
Statement of Cash Flows – Presentation (IAS 7)



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Statement of Cash Flows – Presentation (IAS 7)



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IAS 2 – Inventories

Readings: Chapter 9

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Inventories – Definition

Inventories are assets:

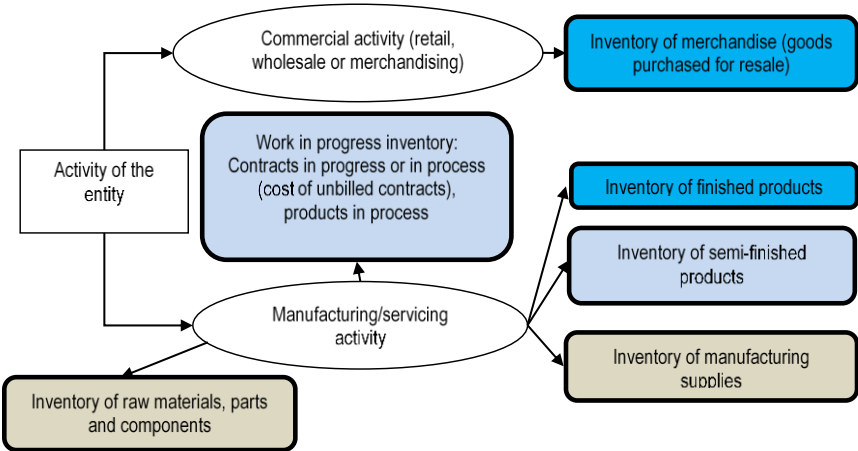
- held for sale in the ordinary course of business
- in the process of production for such sale **or**
- in the form of materials or supplies to be consumed in the production process or in the rendering of services

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Inventories – Classification



Source: Figure 9.2 from Stolowy, Ding & Paugam (2024)

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Inventories – Classification examples



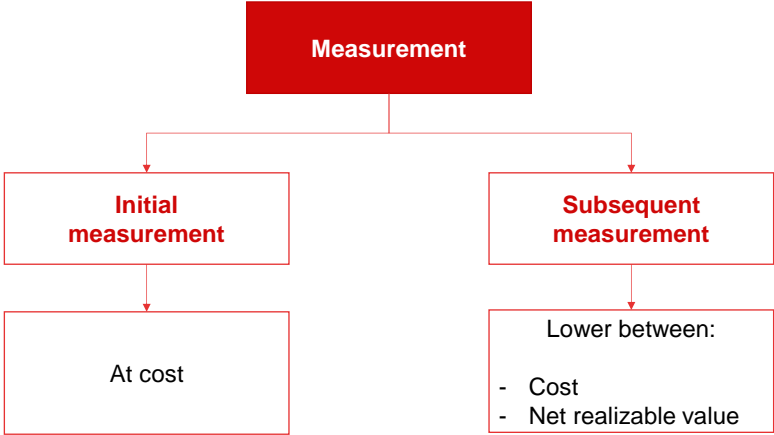
Activity	Name of the goods	Definition	Examples
Commercial activity	Merchandise	Goods purchased for resale without transformation	Wholesale and retail activities
Manufacturing activity	Raw materials, parts, components, and consumables	Goods that, once incorporated into the production process, become integrally and physically part of the product	Electronic parts in a computer manufacturing business
	Manufacturing supplies	Items used in supporting production and not part of the product	Machine fluids, cleaning materials, spare parts
	Work in process, called work in progress (WIP) by IASB	Products still in the manufacturing process at the close of the day and services rendered but not invoiced	Chassis and parts of a computer still on the assembly line at the end of the day
	Semi-finished goods	Items that are finished with regard to one stage of production but are nonetheless not sellable in that condition. They will generally be integrated in a finished product at a later date	Subassembly of the chassis of a computer waiting to receive the microprocessor and the skirt, once the customer order is known
	Finished goods	Completed products ready for sale	Computers ready to be shipped
Service activity	Work in progress	Accumulated costs incurred in the process of fulfilling a contractual obligation to a customer and not yet billed to that customer	Consultancy projects, lawsuits, engineering projects

Source: Table 9.1 from Stolowy, Ding & Paugam (2024)

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Inventories – Measurement



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Cost of inventories comprises:

costs of conversion (direct labor + variable production overheads + fixed production overheads allocated based on normal production capacity) **and**

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Net realizable value =

- Estimated selling price
- Estimated costs of completion
- Estimated costs necessary to make the sale

Net realizable value may fall below cost when:

- Selling prices decline
- Inventories are damaged or become obsolete

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Inventories – Net realizable value (2/2)

Materials and other supplies are only written down when the finished goods in which they will be incorporated are expected to be sold below cost

The amount of any write-down of inventories to net realizable value shall be recognized as an expense of the period

The amount of any reversal of any write-down of inventories (reversal is limited to the amount of the original write-down) shall be recognized as a reduction in the amount of inventories recognized as an expense of the period

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Inventories – Recognition as an expense

When inventories are sold

The carrying amount of the inventories is recognized as an expense in the same period of the related revenue

Inventories allocated to a long-term asset (ex: incorporated in the self-construction of a PPE) are recognized as an expense during the useful life of that asset

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Costing formulas for withdrawals

Specific identification	Inventories withdrawn are valued at specific cost Items are not ordinarily interchangeable (ex: jewels, paintings, custom orders)
FIFO	Inventories withdrawn are valued batch by batch in the order in which they first entered (first in, first out) Items are fungible or interchangeable
WAC	Inventories withdrawn are valued at the average cost (weighted average cost) Items are fungible or interchangeable

LIFO is not allowed under IAS 2

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Impact of using different costing formulas

Context	Impact on net income		Impact on ending inventory	
Rising costs	FIFO	→ higher income reported	FIFO	→ higher ending inventory reported
	WAC	→ medium income reported	WAC	→ medium ending inventory reported
	LIFO	→ lower income reported	LIFO	→ lower ending inventory reported
Falling costs	FIFO	→ lower income reported	FIFO	→ lower ending inventory reported
	WAC	→ medium income reported	WAC	→ medium ending inventory reported
	LIFO	→ higher income reported	LIFO	→ higher ending inventory reported

Source: Table 9.5 from
Stolowy, Ding & Paugam
(2024)

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Inventories – Recording systems

Two systems:

Perpetual (or permanent) inventory system → In Portugal, mandatory for firms that are not micro entities

Periodic inventory system

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Perpetual inventory system

Continuous recording of changes in inventories:

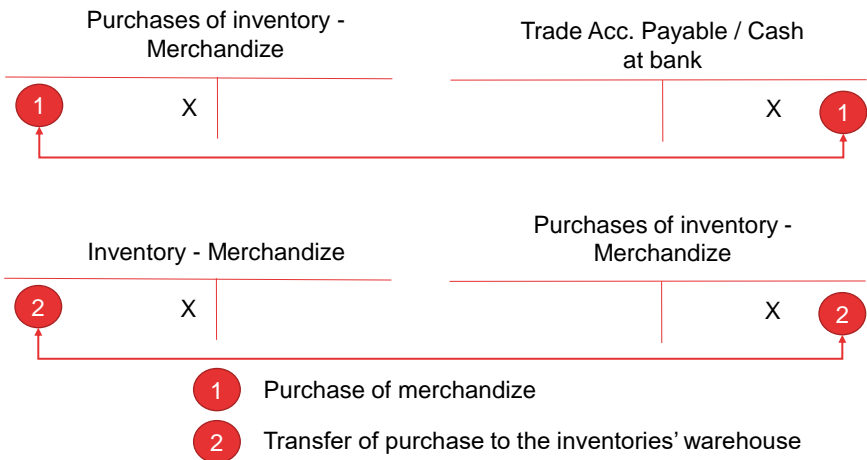
Perpetual inventory account	
Asset increase	Asset decrease
<ul style="list-style-type: none">Beginning inventoryPurchases (cost of goods purchased) or additions to the inventory (cost of goods manufactured)	<ul style="list-style-type: none">Withdrawals from inventory (cost of goods sold or cost of goods consumed in the next segment of the 'manufacturing' process)
Balance: Ending inventory (by deduction)	

Ending inventory = Beginning inventory + Purchases or additions - Withdrawals

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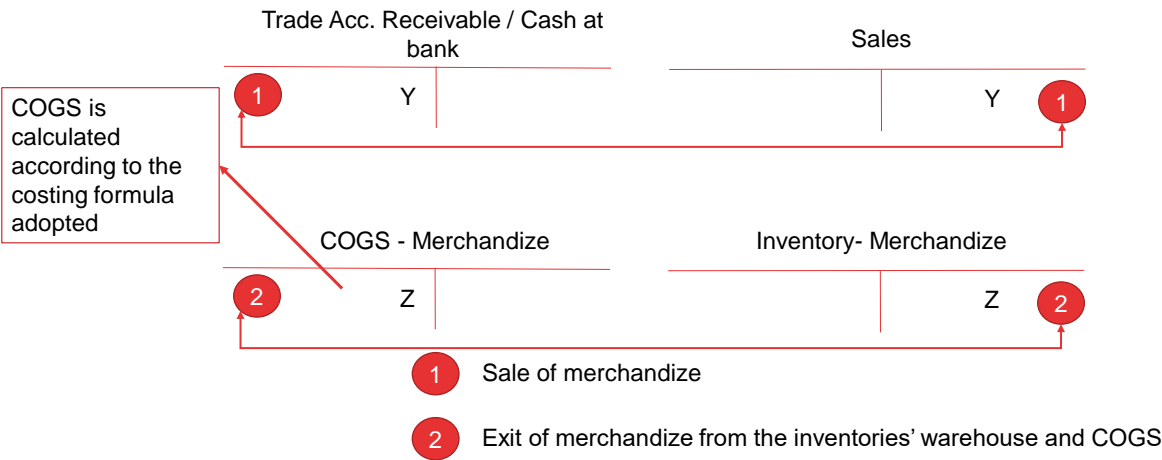
Perpetual inventory system: Recordings for the purchase of merchandize



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Perpetual inventory system: Recordings for the sale of merchandize



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Periodic inventory system

No recording of changes in inventories throughout the year → need to do a physical count of inventories in the warehouse at year end

Periodic inventory account	
Asset increase	Asset decrease
<ul style="list-style-type: none">▪ Beginning inventory (opening balance)▪ Ending inventory (measured at year end)	<ul style="list-style-type: none">▪ Beginning inventory (assumed consumed)
Balance: Ending inventory (measured at year end)	

COGS = Beginning inventory + Purchases or additions – Ending inventory

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Inventories – Disclosures (§ 36)

- the accounting policies adopted in measuring inventories, including the cost formula used
- the total carrying amount of inventories and the carrying amounts according to inventories' classifications (ex: merchandize, materials and supplies, work in progress, finished goods)
- the amount of inventories recognized as an expense during the period
- the amount of any write-down, or any reversal of any write-down, of inventories recognized in the period
- the circumstances or events that led to the reversal of a write-down of inventories
- the carrying amount of inventories pledged as security for liabilities

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IAS 16 – Property, Plant and Equipment

Readings: Chapter 7

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PPE – Definition



Property, Plant and Equipment are tangible (physical substance) assets that (IAS 16, § 6):

are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes **and**

are expected to be used during more than one period

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PPE – Recognition

The cost of an item of property, plant and equipment shall be recognized as an asset when (IAS 16, § 7):

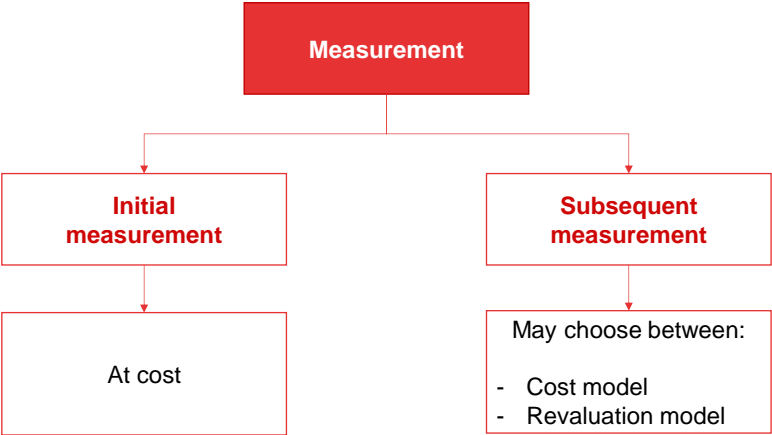
it is probable that future economic benefits associated with the item will flow to the entity **and** the cost of the item can be measured reliably

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PPE – Measurement



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PPE – Initial measurement

Initially measured at cost, comprising (IAS 16, § 16):

purchase price, including import duties and non-refundable taxes, after deducting trade discounts and rebates

any costs directly attributable to bringing the asset to the location and condition necessary to operate the way intended by management

the initial estimate of the costs of dismantling and removing the item and restoring the site where it is located

The carrying amount of an item of property, plant and equipment may be reduced by government grants in accordance with IAS 20

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PPE – Subsequent measurement

An entity shall choose the accounting policy for measuring PPE between two alternatives (IAS 16, § 29):

- cost model **or**
- revaluation model

An entity must apply the chosen accounting policy to an entire class of property, plant and equipment

An entity may switch the accounting policy in case it provides more reliable and relevant information → IAS 8 (retrospective application)

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PPE – Examples of classes

Examples of classes (groups with similar nature) of PPE (IAS 16, § 37):

land
land and buildings
machinery
motor vehicles
furniture
office equipment

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PPE – Cost model for subsequent measurement

Cost – Accumulated Depreciation – Accumulated Impairment Losses

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PPE – Revaluation model for subsequent measurement



**Revalued amount – Subsequent Accumulated Depreciation
– Subsequent Accumulated Impairment Losses**

- Revalued amount is the fair value at the moment of the revaluation
- The frequency of revaluations depends upon changes in fair values (existence of material differences between fair value and carrying amount)
- If an item of PPE is revalued, the entire class of PPE to which that asset belongs shall be revalued.

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PPE – Accounting for a revaluation



Asset's carrying amount is increased:

→ the increase is recognized in equity (revaluation surplus) → other comprehensive income (OCI)

→ the increase is recognized in P&L, to the extent that it reverses a revaluation decrease for the same asset previously recognized in P&L

Asset's carrying amount is decreased:

→ the decrease is recognized in P&L

→ the decrease is recognized in equity (revaluation surplus) → other comprehensive income (OCI), to the extent that it reverses a revaluation increase for the same asset previously recognized in equity (revaluation surplus)

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PPE – Revaluation surplus

As the asset is used: the difference between the depreciation based on the revalued carrying amount of the asset and the depreciation based on the asset's original cost may be transferred to Retained Earnings (not to P&L)

When the asset is derecognized (asset is retired or disposed of): revaluation surplus may be transferred directly to Retained Earnings (not to P&L)

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PPE – Depreciation (1/2)

Depreciation (§ 6): it is the systematic allocation of the depreciable amount of an asset over its useful life

Depreciable amount (§ 6): is the cost of an asset, or other amount substituted for cost, less its residual value

Residual value (§ 6): is the estimated amount that an entity would currently obtain from disposal of the asset at the end of its useful life

Useful life (§ 6): the period over which an asset is expected to be available for use by an entity or the number of production or similar units (ex: kilometers for a vehicle) expected to be obtained from the asset by an entity

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PPE – Depreciation (2/2)

Depreciation of an asset begins when it is in the location and condition necessary for it to be capable of operating in the manner intended by management

A variety of depreciation methods is allowed (ex: the straight-line method, the diminishing balance method and the units of production method). The chosen method shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity

Each part of an item of PPE with a significant cost in relation to the total cost of the item shall be depreciated separately (§ 43) → depreciation by component

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PPE – Derecognition

The carrying amount of PPE shall be derecognised:

- on disposal **or**
- when no future economic benefits are expected from its use

The gain or loss arising from the derecognition shall be determined as the difference between the net disposal proceeds and the carrying amount

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PPE – Disclosure

For each class of PPE:

- the measurement bases, the depreciation methods and the useful lives or the depreciation rates used
- a reconciliation of the carrying amount at the beginning and end of the period
- any restrictions on title of PPE
- revaluation information (date, use of independent valuer, revaluation surplus and carrying amount that would have been recognized had the asset been carried under the cost model)
- other information considered relevant for users (§ 79)

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IAS 38 – Intangible Assets

Readings: Chapter 8

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Intangible assets – Definition

Intangible assets are identifiable non-monetary assets without physical substance

Examples:

- Goodwill (IFRS 3 *Business Combinations*)
- Patents, Franchises, Licenses, Trademarks, Copyrights, Acquired brand names and Acquired customer lists
- Capitalized R&D, when certain conditions are met

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Intangible assets – Recognition

The cost of an intangible asset shall be recognized as an asset when (IAS 38, § 18):

the asset is separately identifiable

the entity controls the asset

it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity **and**

the cost of the asset can be measured reliably

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Intangible assets – Goodwill

IFRS 3 *Business Combinations*

No amortization

Annual impairment test (in accordance with IAS 36 *Impairment of assets*)

No reversal of the impairment loss (reversal possible for other intangible assets)

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Intangible assets – Internally generated intangible assets (1/2)

To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into (§52):

research phase **and**
development phase

In case an entity cannot distinguish the two phases → treat as research phase only

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Intangible assets – Internally generated intangible assets (2/2)



Research phase → expenditure recognized as an expense

Development phase → recognize an intangible asset in case a series of cumulative conditions are met, namely:

- intention and feasibility for conclusion and future use/sale
- existence of a market for the output of the intangible asset or usefulness
- availability of resources to complete the development and to use/sell the asset
- ability to measure reliably the expenditure

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Intangible assets – Other items internally generated



Expenditures on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole → not recognized as intangible assets

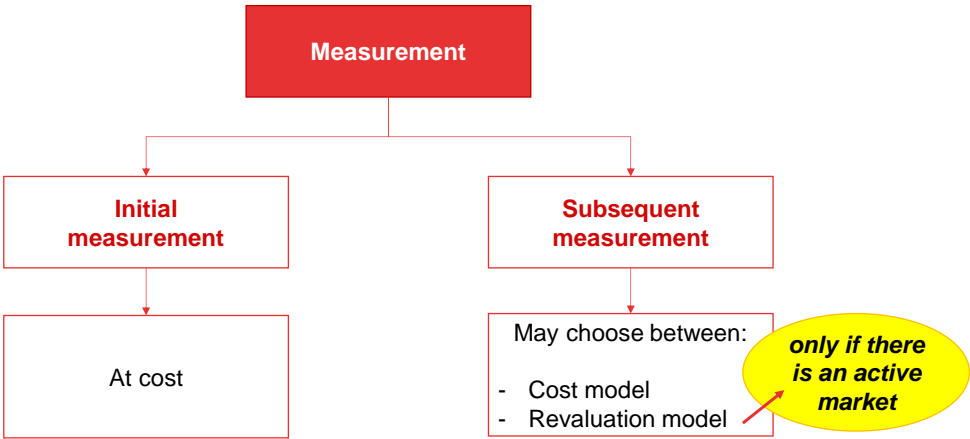
These intangibles can only be recognized at their fair value when acquired as part of a business combination, separately from goodwill (IFRS 3)

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Intangible assets – Measurement



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Intangible assets – Initial measurement

Initially measured at cost, comprising (IAS 38, § 27):

purchase price, including import duties and non-refundable taxes, after deducting trade discounts and rebates any directly attributable cost of preparing the asset for its intended use


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Intangible assets – Subsequent measurement



An entity shall choose the accounting policy for measuring intangible assets between two alternatives (IAS 38, § 72):

- cost model **or**
- revaluation model 

An entity may switch the accounting policy in case it provides more reliable and relevant information → IAS 8 (retrospective application)

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Intangible assets – Cost model for subsequent measurement



Cost – Accumulated Amortization– Accumulated Impairment Losses

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Intangible assets – Revaluation model for subsequent measurement



only if there
is an active
market

Revalued amount – Subsequent Accumulated Amortization
– Subsequent Accumulated Impairment Losses

- Revalued amount is the fair value at the moment of the revaluation
- The frequency of revaluations depends upon changes in fair values (existence of material differences between fair value and carrying amount)

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Intangible assets – Accounting for a revaluation



Asset's carrying amount is increased:

→ the increase is recognized in equity (revaluation surplus) → other comprehensive income (OCI)

→ the increase is recognized in P&L, to the extent that it reverses a revaluation decrease for the same asset previously recognized in P&L

Asset's carrying amount is decreased:

→ the decrease is recognized in P&L

→ the decrease is recognized in equity (revaluation surplus) → other comprehensive income (OCI), to the extent that it reverses a revaluation increase for the same asset previously recognized in equity (revaluation surplus)

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Intangible assets – Revaluation surplus

As the asset is used: the difference between the depreciation based on the revalued carrying amount of the asset and the depreciation based on the asset’s original cost *may be transferred* to Retained Earnings (not to P&L)

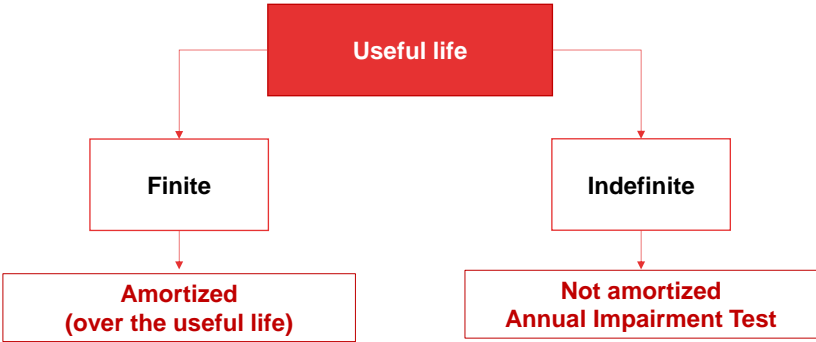
When the asset is derecognized (asset is retired or disposed of): revaluation surplus *may be transferred* directly to Retained Earnings (not to P&L)

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Intangible assets – Useful life



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Intangible assets – Amortization (1/2)

Amortization (§ 8): it is the systematic allocation of the depreciable amount of an asset over its useful life

Depreciable amount (§ 8): is the cost of an asset, or other amount substituted for cost, less its residual value

Residual value (§ 8): is the estimated amount that an entity would currently obtain from disposal of the asset at the end of its useful life

Useful life (§ 8): the period over which an asset is expected to be available for use by an entity or the number of production or similar units (ex: number of years we expect to use a patent) expected to be obtained from the asset by an entity

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Intangible assets – Amortization (2/2)

Amortization of an asset begins when it is in the location and condition necessary for it to be capable of operating in the manner intended by management

A variety of amortization methods is allowed (ex: the straight-line method, the diminishing balance method and the units of production method)

The chosen method shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity

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Intangible assets – Derecognition

The carrying amount shall be derecognised:

- on disposal **or**
- when no future economic benefits are expected from its use

The gain or loss arising from the derecognition shall be determined as the difference between the net disposal proceeds and the carrying amount

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Intangible assets – Disclosure

For each class of Intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortization rates used, as well as the amortization methods used for intangible assets with finite useful lives;
- a reconciliation of the carrying amount at the beginning and end of the period;
- revaluation information (date, revaluation surplus and carrying amount that would have been recognized had the asset been carried under the cost model);
- the aggregate amount of research and development expenditure recognized as an expense during the period;
- other information considered relevant for users (§ 128).

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IAS 36 – Impairment of Assets

Readings: Chapter 7 (3)

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Impairment of assets – Indication of impairment



IAS 36 § 9 and § 12:

At the end of each reporting period, an entity shall verify whether there is any indication that an asset may be impaired, using information from:

External sources

Internal sources

If any such indication exists, the entity shall estimate the recoverable amount of the asset

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Impairment of assets – External sources



Observable indications that the asset's value has declined below normal depletion (usage/passage of time)

Changes in technological, market, economic or legal environment

Increase in market interest rates (decline of value in use)

The carrying amount of the net assets of the entity is more than its market capitalisation

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Impairment of assets – Internal sources



Obsolescence or physical damage of the asset

Asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite

Economic performance of the asset is, or will be, worse than expected

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Impairment of assets – Definition

Impairment exists when (IAS 36 § 1):



Impairment Loss = Carrying amount – Recoverable amount

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Sale value minus costs of disposal

Fair value (§ 6) → is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Costs of disposal (§ 6) → incremental costs directly attributable to the disposal of an asset (excluding finance costs and income tax) → Examples: legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and other direct costs necessary to sell the asset

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Value in use

Determining value in use of an asset involves the following steps (§ 31):

Estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal **and**

Applying a discount rate to those future cash flows

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Impairment of assets – Recognition

An impairment loss is recognized immediately in profit or loss, except when it is related to a revalued asset for which there is a revaluation surplus → treated as a revaluation decrease → recognized in other comprehensive income (OCI) to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset

Reversal of impairment losses → the new carrying amount shall not exceed the carrying amount that would have been determined (net of amortization/depreciation) had no impairment loss been recognized in previous years

The depreciation/amortization shall be adjusted based on the asset's revised carrying amount, less its residual value, on a systematic basis, over its remaining useful life

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Impairment of assets – Disclosures

For each class of assets:

- The amount of impairment losses and reversals recognized in profit or loss
- The amount of impairment losses and reversals on revalued assets recognized in other comprehensive income
- Segment information (IFRS 8)

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IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

Readings: Chapter 12 (6)

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Provision – Definition

IAS 37 § 10:

Provision: liability of uncertain timing or amount

Provision recognized when (3 cumulative conditions):

- an entity has a present obligation (legal or constructive) as a result of a past event
- it is probable that an outflow of resources will be required to settle the obligation **and**
- the amount can be estimated reliably

the event is
more likely than
not to occur

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Provision – Initial measurement

The best estimate of the amount to be considered should take into consideration:

- Judgement of management based on past experience of similar transactions and, in some cases, experts may be involved
- Use of expected value (considering different outcomes and probabilities)
- Measured before tax

Estimates should be discounted to present value when the effect of the time value of money is material

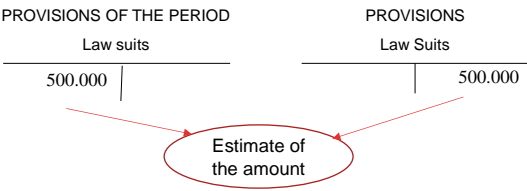
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Provision – Example of initial recognition and measurement



There is a law suit against the entity for which the entity’s lawyers consider that it is probable that the entity will need to pay 500.000 € to settle the obligation



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Provision – Subsequent measurement



Reviewed at the end of each reporting period:

- Reassess whether recognition criteria is met → if any of the 3 cumulative conditions is not met, reverse the provision
- reassess amount of provision → when recognition criteria is met the amount for which the provision is recognized should be reviewed to reflect the best estimate at the end of the reporting period.

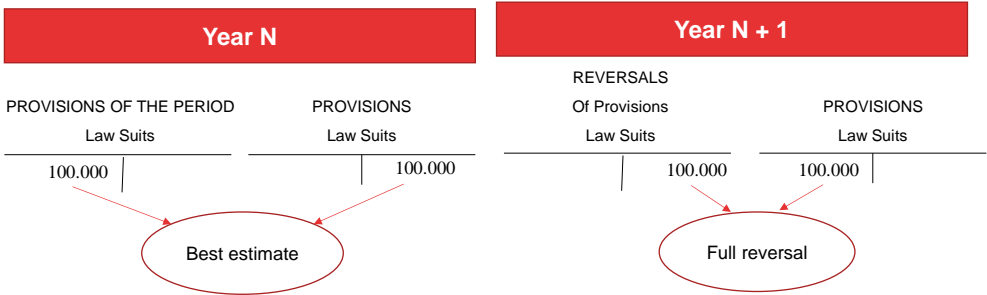
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Provision – Example of a reversal

A former worker is claiming in court for a compensation of 100.000€ and a provision was recognized in year N. The following year, in face of new evidence, the entity's lawyers consider that it is not probable that the entity will need to pay the compensation.



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Use of Provisions

A provision shall be used only for expenditures for which the provision was originally recognized

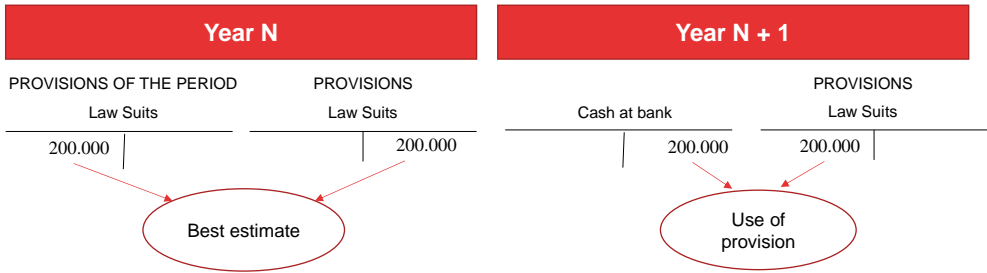
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Provision – Example of use

A former worker is claiming in court for a compensation of 200.000€ and a provision was recognized in year N. The following year, the entity is sentenced to paying the compensation. The entity’s lawyer decided no to file for an appeal.



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Provision – Specific cases (1/2)

Future operating losses:

- Shall not be recognized as a provision

Onerous contracts:

- Contracts that have more unavoidable costs than expected economic benefits
- Shall be recognized as a provision

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Provision – Specific cases (2/2)

Restructuring provisions:

- Sale or termination of a line of business
- The closure of business locations in a country or region or the relocation of business activities
- Changes in the management structure
- Fundamental reorganizations

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Provision – Disclosures

For each class of provision:

Carrying amount (beginning and end of period), additions and increases, reversals, amounts used, increases due to passage of time
Other disclosures (§ 85 – 92)

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Contingent liabilities

Contingent liabilities are either:

- Possible obligations (to be confirmed whether the entity has a present obligation) **or**
- Present obligations that do not meet the recognition criteria

Contingent liabilities are not recognized as liabilities

Contingent liabilities are disclosed in the Notes, unless the possibility of an outflow of resources is remote

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Contingent assets

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

Contingent assets are not recognized as assets

Contingent assets are disclosed in the Notes when it is probable that there will be an inflow of economic benefits

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Provisions – Decision tree

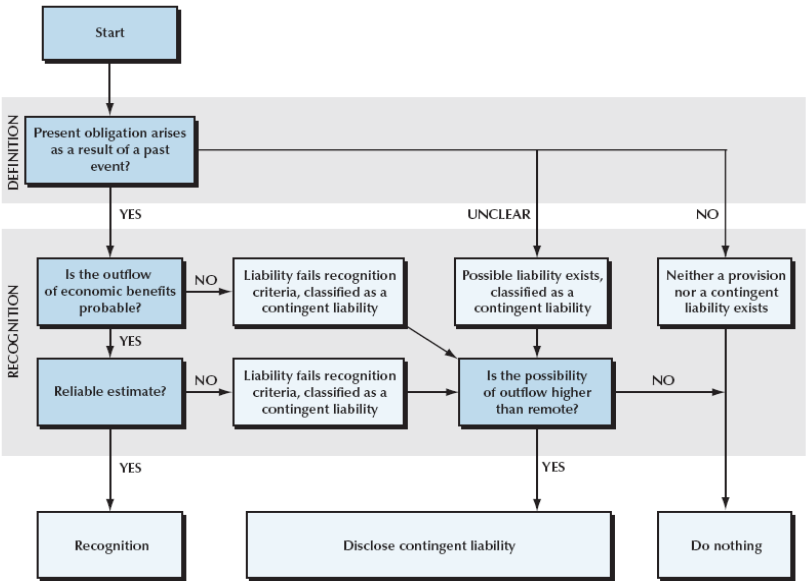


FIGURE 5.2 Decision tree
Source: Ernst & Young (2002b).

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