DIGITAL CFO SOLUTIONS • IFRS SERIES

ACTIVE STANDARD

INTERNATIONAL FINANCIAL REPORTING STANDARDS

IAS 37

Provisions, Contingent Liabilities & Contingent Assets

Recognition, measurement and disclosure of provisions — onerous contracts, restructuring, and the contingency decision tree, updated for the IASB's targeted improvements and IFRS 18

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ROADMAP

What We Will Cover

Foundations & Core Principle

Objective, scope, and the key definitions behind a provision

Recognition of Provisions

The three recognition conditions, and legal vs constructive obligations

Measurement of Provisions

Best estimate, discounting, risks and future events

Reimbursements & Changes

Separate recognition of reimbursements, and the review of provisions over time

Onerous Contracts & Restructuring

Unavoidable costs, and which restructuring costs qualify for a provision

Contingent Liabilities & Assets

Why they are disclosed rather than recognised, and the decision tree that separates them

Disclosure Requirements

The provisions reconciliation, and contingency disclosures

Recent Developments

The IASB's targeted improvements to IAS 37, and the impact of IFRS 18

PART I — FOUNDATIONS

Foundations & Core Principle

The objective and scope of IAS 37, and the definitions that separate a provision from a mere contingency.

FOUNDATIONS

Objective & Scope

IAS 37 ensures that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets, and that sufficient information is disclosed for users to understand their nature, timing and amount.

- IAS 37 applies to all entities in accounting for provisions, contingent liabilities and contingent assets, EXCEPT where another Standard specifically addresses the item.
- Excluded from scope: items covered by IAS 12 (income taxes), IFRS 16 (leases), IFRS 15 (revenue, e.g. warranties bundled as a performance obligation), IAS 19 (employee benefits), IFRS 17 (insurance contracts), and financial instruments within IFRS 9.
- Executory contracts — contracts under which neither party has performed any of its obligations, or both have partially performed to an equal extent — are outside IAS 37, UNLESS the contract is onerous.
- IAS 37 does not apply where another Standard already provides its own recognition and measurement model for a provision-like item — such as depreciation, impairment, or doubtful debts.

FOUNDATIONS

Key Definitions

Four terms determine whether a present obligation exists at all — and therefore whether IAS 37 requires recognition, disclosure, or nothing.

Provision

A liability of uncertain timing or amount — the defining feature that separates a provision from an ordinary trade payable.

Obligating Event

An event that creates a legal or constructive obligation, leaving the entity no realistic alternative to settling that obligation.

Legal Obligation

An obligation that derives from a contract (explicit or implicit terms), legislation, or other operation of law.

Constructive Obligation

An obligation that derives from an entity's own actions — established practice, published policies, or a sufficiently specific statement — that creates a valid expectation others will rely on.

PART II — RECOGNITION

Recognition of Provisions

All three conditions must be satisfied before a provision is recognised — and the nature of the underlying obligation determines whether the first condition is even met.

RECOGNITION

The Three Recognition Conditions

A provision is recognised only where ALL THREE conditions below are met — if any one fails, no provision is recognised, though disclosure as a contingent liability may still be required.

1 Present Obligation

The entity has a present obligation (legal or constructive) as a result of a past event.

2 Probable Outflow

It is probable — more likely than not — that an outflow of resources embodying economic benefits will be required to settle the obligation.

3 Reliable Estimate

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

RECOGNITION

Legal vs Constructive Obligations

The obligating event determines whether a present obligation actually exists — IAS 37 recognises two distinct routes to one.

- A LEGAL obligation arises from a contract (through explicit or implicit terms), legislation, or other operation of law.
- A CONSTRUCTIVE obligation arises from an entity’s own actions, where established patterns of past practice, published policies, or a sufficiently specific current statement have created a valid expectation in other parties that it will discharge those responsibilities.
- A constructive obligation to RESTRUCTURE arises only when an entity has a detailed formal plan for the restructuring, AND has raised a valid expectation in those affected — by starting to implement the plan, or announcing its main features to those affected.
- A mere management or board decision to restructure does NOT, on its own, create a constructive obligation at the reporting date — implementation or communication to those affected must already have begun.
- Provisions are NOT recognised for future operating losses — these fail the definition of a liability, since they relate to future events rather than a present obligation arising from a past event.

WORKED ILLUSTRATIONS

Illustration I — Legal vs Constructive Obligation

FACT PATTERN

A chemical company has caused land contamination in a country with no environmental legislation. The company has a widely publicised policy of cleaning up all contamination it causes, and has a long, consistent record of honouring that policy. Required: does the company have a present obligation, and should a provision be recognised?

SOLUTION

Although there is no LEGAL obligation — no environmental legislation requires clean-up — the company's published policy and consistent past practice create a CONSTRUCTIVE obligation, since they have created a valid expectation among those affected that the company will clean up the contamination.

The obligating event is the contamination itself, which has already occurred.

Provided an outflow of resources is probable and a reliable estimate can be made, a PROVISION should be recognised for the best estimate of the clean-up costs.

Had the company had no such established policy, no obligation would exist and no provision would be recognised — disclosure of a contingent liability might still be considered, depending on the facts.

PART III — MEASUREMENT

Measurement of Provisions

The amount recognised is the best estimate of the expenditure required to settle the obligation — refined by discounting, risk, and future events.

MEASUREMENT

The Best Estimate

The method used to estimate a provision depends on the nature of the population of items being measured.

Expected Value Method

Where a provision involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities — typically used for warranty provisions across many units sold.

Most Likely Outcome

Where a single obligation is being measured, the individual most likely outcome may be the best estimate — adjusted where other possible outcomes are mostly higher or mostly lower, to reflect that skew.

MEASUREMENT

Discounting, Risk & Future Events

Beyond the basic estimation method, four further factors refine how a provision is measured.

- RISKS AND UNCERTAINTIES that inevitably surround events and circumstances are taken into account in reaching the best estimate — but uncertainty does not justify creating excessive provisions or deliberately overstating liabilities.
- Where the effect of the TIME VALUE OF MONEY is material, a provision is discounted to present value using a pre-tax rate reflecting current market assessments of the time value of money and the risks specific to the liability.
- The UNWINDING OF THE DISCOUNT over time is recognised as a finance cost in profit or loss — not as an adjustment to the original operating expense.
- FUTURE EVENTS that may affect the amount required to settle an obligation are reflected where there is sufficient objective evidence they will occur — for example, expected changes in technology or legislation.
- GAINS FROM THE EXPECTED DISPOSAL OF ASSETS are NOT taken into account in measuring a provision, even where the disposal is closely linked to the event giving rise to it — they are recognised separately, at the time of disposal.

Illustration II — Warranty Provision (Expected Value Method)

FACT PATTERN

A manufacturer sells goods with a warranty covering the cost of repairs for defects appearing within six months of purchase. Past experience shows that if minor defects were found in ALL products sold, repair costs would be $1,000,000; if major defects were found in ALL products sold, repair costs would be $4,000,000. Past experience also shows that 75% of goods sold have no defects, 20% have minor defects, and 5% have major defects. Required: estimate the warranty provision using the expected value method.

SOLUTION

Outcome	Probability	Cost If It Occurs	Expected Value
No defects	75%	$0	$0
Minor defects	20%	$1,000,000	$200,000
Major defects	5%	$4,000,000	$200,000
Total expected value			$400,000

Warranty provision = $0 + $200,000 + $200,000 = $400,000 — the expected value method is appropriate here because the provision covers a large population of warranty claims, not a single obligation.

WORKED ILLUSTRATIONS

Illustration III — Discounting a Decommissioning Provision

FACT PATTERN

An entity is required to decommission an offshore platform at the end of its 10-year useful life. The estimated decommissioning cost, payable in 10 years, is $10,000,000. A pre-tax discount rate reflecting current market assessments of the time value of money and risks specific to the liability is 6% per annum. Required: the provision to be recognised at inception, and the finance cost in year 1.

SOLUTION

Present value = $10,000,000 ÷ $(1.06)^{10}$ = $10,000,000 × 0.5584 = $5,584,000

Provision recognised at inception = $5,584,000 — capitalised as part of the cost of the platform under IAS 16, since the obligation arises on acquisition of the asset.

Year 1 finance cost (unwinding of the discount) = $5,584,000 × 6% = $335,040

Carrying amount of the provision at the end of year 1 = $5,584,000 + $335,040 = $5,919,040

The finance cost is recognised in profit or loss each year as the discount unwinds, until the provision reaches its full $10,000,000 undiscounted amount at the decommissioning date.

MEASUREMENT

Reimbursements

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party — such as through an insurance contract — the reimbursement is treated as a SEPARATE asset, not as a reduction of the provision.

- The reimbursement is recognised ONLY when it is VIRTUALLY CERTAIN that reimbursement will be received if the entity settles the obligation.
- The amount recognised for the reimbursement does not exceed the amount of the provision itself.
- In the statement of financial position, the reimbursement asset and the provision are presented SEPARATELY — they are not offset against each other.
- In the statement of profit or loss, however, the expense relating to the provision MAY be presented net of the reimbursement recognised.

MEASUREMENT

Changes in & Use of Provisions

1 Review at Each Reporting Date

Provisions are reviewed at the end of each reporting period and adjusted to reflect the current best estimate; if an outflow is no longer probable, the provision is reversed.

2 Use Only for the Original Purpose

A provision is used only for expenditures for which it was originally recognised — charging unrelated expenditure against it would obscure the impact of two different events.

3 Unwinding of the Discount

Where a provision is measured at present value, the increase reflecting the passage of time is recognised as a finance cost, not as an adjustment to the original expense.

PART IV — ONEROUS CONTRACTS & RESTRUCTURING

Onerous Contracts & Restructuring Provisions

Two of the most heavily tested applications of IAS 37 — each with its own strict test for what may, and may not, be provided for.

Recognition & Measurement

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received.

PROVISION FOR AN ONEROUS CONTRACT = THE LOWER OF

The cost of fulfilling the contract

Any compensation or penalties from failing to fulfil it (the cost of exiting)

Before recognising a separate onerous-contract provision, an entity first recognises any impairment loss on assets dedicated to that contract under IAS 36. The cost of fulfilling a contract comprises costs that relate directly to it — both incremental costs and an allocation of other costs that relate directly to fulfilling contracts.

Illustration IV — Onerous Contract Provision

FACT PATTERN

An entity operates a factory under a non-cancellable service contract with three years remaining, at an annual unavoidable cost of $500,000. Due to a downturn, the entity derives no further economic benefit from the contract and cannot exit it without penalty. Required: determine the provision to be recognised.

SOLUTION

Remaining unavoidable payments = $500,000 × 3 years = $1,500,000

Since the entity derives no economic benefit from the contract, the entire remaining obligation is unavoidable and the contract is onerous.

Provision for the onerous contract = $1,500,000, discounted to present value if the effect of the time value of money is material.

Note: under IFRS 16, a lessee's own property leases are generally recognised as right-of-use assets and lease liabilities, and tested for impairment under IAS 36 rather than as an IAS 37 onerous contract — the onerous-contract test today applies primarily to executory contracts outside IFRS 16's scope, such as onerous service or supply contracts.

RESTRUCTURING PROVISIONS

Which Costs Qualify?

A restructuring provision is recognised only once the constructive-obligation test is met — and even then, only a narrow set of costs qualifies.

Costs Included

Direct expenditures from the restructuring that are BOTH necessarily entailed by it AND not associated with the entity's ongoing activities — such as employee termination benefits and the costs of closing facilities.

Costs Excluded

Retraining or relocating continuing staff, marketing, and investment in new systems or distribution networks — these relate to the future conduct of the business. Future operating losses up to the restructuring date are also excluded, unless they relate to an onerous contract.

WORKED ILLUSTRATIONS

Illustration V — Restructuring Provision

FACT PATTERN

On 1 December 2025, the board of an entity approved a detailed formal plan to close a division, and announced it to affected employees and customers before the 31 December 2025 year end. The plan involves employee termination costs of $2,000,000, costs of closing the facility of $500,000, $300,000 to relocate continuing staff to other divisions, and $150,000 to retrain continuing employees. Required: the restructuring provision to be recognised at 31 December 2025.

SOLUTION

Employee termination costs (directly related to the restructuring, not to ongoing activities) = $2,000,000

Costs of closing the facility (directly related) = $500,000

Restructuring provision = $2,000,000 + $500,000 = $2,500,000

EXCLUDED: relocating continuing staff ($300,000) and retraining continuing employees ($150,000) — both relate to the ongoing conduct of the business, so they are expensed as incurred rather than provided for.

The provision is recognised because a detailed formal plan exists and was announced to those affected before the reporting date — satisfying the constructive obligation test.

PART V — CONTINGENCIES

Contingent Liabilities & Contingent Assets

Neither is recognised in the financial statements — the recognition test determines whether an item is a provision, a disclosed contingency, or nothing at all.

Contingent Liabilities & Contingent Assets

Contingent Liability

(a) A possible obligation from past events, confirmed only by uncertain future events not wholly within the entity's control; or (b) a present obligation not recognised because an outflow is not probable, or the amount cannot be measured reliably. NOT recognised — disclosed unless the possibility of an outflow is remote.

Contingent Asset

A possible asset from past events, confirmed only by uncertain future events not wholly within the entity's control. NOT recognised, to avoid recognising income that may never be realised — disclosed when an inflow is probable. Once realisation is virtually certain, it is no longer contingent and IS recognised.

CONTINGENCIES

The Recognition & Disclosure Decision Tree

Applied in sequence, these four questions determine whether an item is recognised as a provision, disclosed as a contingent liability, or requires no action at all.

1 Present Obligation from an Obligating Event?

If only a POSSIBLE obligation exists (not a present one), the item moves directly to the contingent liability disclosure test.

2 Probable Outflow of Resources?

If a present obligation exists but an outflow is NOT probable, no provision is recognised — disclose as a contingent liability unless the possibility of an outflow is remote.

3 Reliable Estimate Possible?

If an outflow is probable but a reliable estimate cannot be made (rare), disclose as a contingent liability rather than recognising a provision.

4 Recognise a Provision

Where a present obligation exists, an outflow is probable, AND a reliable estimate can be made, a provision is recognised for the best estimate.

WORKED ILLUSTRATIONS

Illustration VI — Applying the Decision Tree

FACT PATTERN

A customer is suing a company for damages of $2,000,000 arising from a faulty product. At the current year end, the company's lawyers advise that, based on developments in the case, it is now PROBABLE the company will be found liable, and estimate the likely damages at $1,200,000. At the PRIOR year end, the lawyers had advised it was only POSSIBLE (not probable) that the company would be found liable. Required: the accounting treatment at the current year end, and how it differs from the prior year end.

SOLUTION

CURRENT YEAR END: a present obligation exists (the faulty product supplied), an outflow is now PROBABLE per legal advice, and a reliable estimate of $1,200,000 can be made — all three recognition conditions are met, so a PROVISION of $1,200,000 is recognised.

PRIOR YEAR END: an outflow was only possible, not probable — the recognition test was not met, so no provision was recognised; instead, the lawsuit was DISCLOSED as a contingent liability, describing its nature and an estimate of its financial effect.

This illustrates how a contingent liability can migrate to a recognised provision purely because new information — here, updated legal advice — changes the probability assessment between reporting dates, with no change in the underlying facts of the case itself.

PART VI — DISCLOSURE

Disclosure Requirements

A reconciliation of the movement in provisions during the period, and separate disclosures for contingent liabilities and contingent assets.

DISCLOSURE

Reconciliation of the Carrying Amount

For each class of provision, an entity discloses a reconciliation showing the movement in the carrying amount during the period.

Movement	Description
Opening balance	Carrying amount at the start of the period
Additional provisions	New provisions made during the period, including increases to existing provisions
Amounts used	Amounts charged against the provision during the period, for the expenditures it was recognised for
Unused amounts reversed	Amounts released back to profit or loss where an outflow is no longer probable
Unwinding of the discount	The increase during the period reflecting the passage of time, and the effect of any change in the discount rate
Closing balance	Carrying amount at the end of the period

Comparative figures are NOT required for this reconciliation. For each class of provision, an entity also describes the nature of the obligation, the expected timing of any outflows, and the uncertainties about their amount or timing.

DISCLOSURE

Contingent Items & the Prejudicial Exemption

1 Contingent Liabilities Disclosed

For each class of contingent liability: a brief description of its nature, an estimate of its financial effect, an indication of the uncertainties over amount or timing, and the possibility of any reimbursement.

2 Contingent Assets Disclosed

Where an inflow of economic benefits is probable: a brief description of the nature of contingent assets at the reporting date, and an estimate of their financial effect, using the same principles as for provisions.

3 The Prejudicial Exemption

In extremely rare cases, disclosure can be expected to seriously prejudice the entity's position in a dispute; an entity need not disclose the detail, but must disclose the general nature of the dispute and the fact — and reason — that information has been withheld.

PART VII — RECENT DEVELOPMENTS

Recent Developments

The IASB’s targeted improvements project, and how IFRS 18 changes where provision-related items are presented.

RECENT DEVELOPMENTS

The IASB's Targeted Improvements to IAS 37

The IASB published the Exposure Draft Provisions—Targeted Improvements on 12 November 2024. As of mid-2026 the Board is still redeliberating feedback — nothing has yet been finalised.

Clearer Recognition Criteria

Proposals would restructure the present-obligation criterion around the Conceptual Framework, clarifying when an obligation conditional on the entity's own future actions is a present obligation.

Specified Discount Rates

Long-term provisions would use a risk-free discount rate, with NO adjustment for the entity's own non-performance risk, and disclosure of the rate and approach used.

Clarified Cost Measurement

Proposals would clarify that measuring an obligation to deliver goods or services includes costs that relate directly to the obligation, addressing diversity in current practice.

Levies Brought Within IAS 37

The proposals fold in guidance from IFRIC 21 Levies and IFRIC 6, clarifying the past-event condition for levies — refined by a tentative February 2026 Board decision.

RECENT DEVELOPMENTS

Impact of IFRS 18 on Presentation

IFRS 18 Presentation and Disclosure in Financial Statements replaces IAS 1 and is effective for annual periods beginning on or after 1 January 2027, with early application permitted.

- IFRS 18 does NOT change IAS 37’s recognition, measurement or disclosure requirements — its impact is confined to presentation.
- Provision-related expenses — restructuring costs, litigation provisions, onerous-contract charges — are classified within the OPERATING category by default under IFRS 18’s structure, unless they relate to an investing or financing activity.
- The unwinding of the discount on a provision continues to be presented as a finance cost, typically within IFRS 18’s financing category, consistent with its nature as a time-value-of-money charge.
- Where an entity discloses a management-defined performance measure that excludes items such as restructuring provisions, IFRS 18 requires a reconciliation to the most directly comparable IFRS-defined subtotal, together with an explanation of why the adjusted measure is useful.

SUMMARY

Key Takeaways

Three Conditions, All Required

Present obligation, probable outflow, and a reliable estimate — miss any one and no provision is recognised.

Constructive Obligations Are Real Obligations

Published policy and consistent past practice can create a liability just as firmly as a signed contract.

Measurement Is More Than a Single Number

Expected value or most likely outcome, discounted where material, but never reduced for expected disposal gains.

Onerous Contracts Use the Lower of Two Costs

The unavoidable cost is the lower of fulfilling the contract and the cost of exiting it.

Contingencies Are Disclosed, Not Recognised

The decision tree — obligation, probability, reliability — is what separates a provision from a footnote.

The Recognition Test Itself Is Under Review

The IASB's targeted improvements refine — not replace — today's framework; IFRS 18 only changes where the numbers sit.

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A Career Built on Making IFRS Understandable

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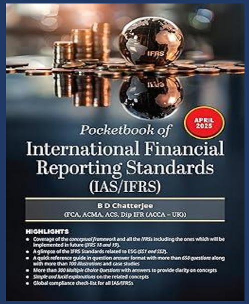

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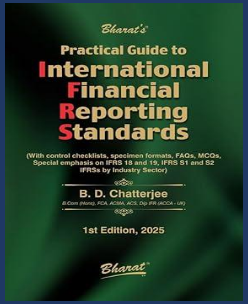

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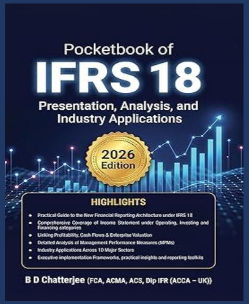

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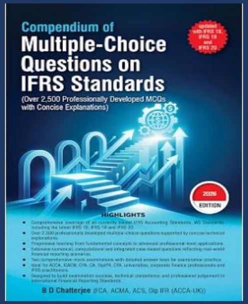

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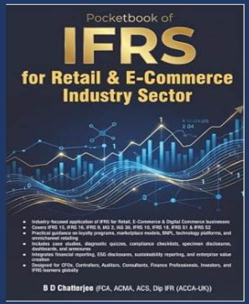

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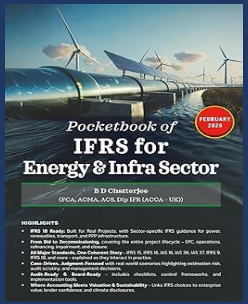

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