Proceedings of International Conference on Scientific Research in Natural and Social Sciences
Hosted online from Toronto, Canada.
Date: 5th April, 2023
ISSN: 2835-5326 **Website:** econferenceseries.com

SOME ISSUES ON THE ASSESSMENT OF THE VALUE OF PROVISIONS AND CONTINGENT LIABILITIES

Nodira Rajabova,
2nd master of Tashkent Financial Institute

Ilyas Ochilov
Doctor of Economics, Docent

Annotation:
This paper examines pricing differences regarding contingencies presented in statements of financial position or notes, which are considered an area for creative accounting. The most important conclusion is that market participants in both countries follow different patterns when incorporating information about provisions and contingent liabilities. More precisely, our results suggest that provisions are value relevant. Contingent liabilities seem to have no value relevance.

Keywords: Provisions, contingent liabilities, contingencies, creative accounting, national culture.

INTRODUCTION

The recognition of "provisions" and the disclosure of "contingent liabilities" have been considered sources of creative accounting, primarily because of judgement used on management estimates. We perform an exploratory analysis to examine whether market participants incorporate information regarding contingencies communicated through financial statements into market prices. We use a sample of firms reporting under International Financial Accounting Standards (IFRS). First, regarding theory, we analyse the effects of recognizing provisions versus disclosing contingent liabilities, and the resulting differences in leverage ratios. Then, we analyse the value relevance of those two contingent elements, differentiating between countries from two different national cultures. In addition, we examine the results distinguishing firms with a risk committee on the board of directors and those without, in order to identify whether our results are positively or negatively changed.

MATERIALS AND METHODS

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term 'contingent' is used for liabilities and assets that are not recognised 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. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

This Standard distinguishes between:

(a) provisions – which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

(b) contingent liabilities – which are not recognised as liabilities because they are either:

(i) possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

(ii) present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

A provision shall be recognised when:

a) an entity has a present obligation (legal or constructive) as a result of a past event;
b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
c) a reliable estimate can be made of the amount of the obligation. If these

conditions are not met, no provision shall be recognised.

RESULTS AND DISCUSSION

It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the statement of financial position. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.

In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they are not included in the provision.

Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

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

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity.

CONCLUSION

This paper has some limitations. Many entities can report the maximum amount payable, rather than a best estimate, for contingencies, while measurement of provisions is more likely to reflect the best estimate. While we analysed all the content on notes, and we believe the firms in the sample used the best estimate for both, our reading could be biased. We acknowledge this aspect as a limitation, because we did not control for situations in which the best estimate versus maximum amount payable could occur, interpreting both would be the same.

REFERENCES

1. Gowthorpe C and Amat O (2005) Creative Accounting: Some Ethical Issues of Macro and Micro- Manipulation. Journal of Business Ethics 57: 55-64.
2. Hellman N, Gray SJ, Morris RD, and Haller A (2015) The Persistance of International Accounting Differences as Measured on Transitions to IFRS. Accounting and Business Research 45(2): 166- 195.
3. Hofstede G (2001) Culture's Consequences: Comparing Values, Behaviors, Institutions, and Organizations Across Nations. Thousand Oaks, CA: Sage Publications.
4. Jaafar A and McLeay, S (2007) Country Effects and Sector Effects on the Harmonization of Accounting. Abacus 43(2): 156-189.
5. Leone M (2010) What's on the SEC's Radar? Available at: http://ww2.cfo.com/accounting-tax/2010/09/whats-on-the-secs-radar (accessed 26 May 2015).