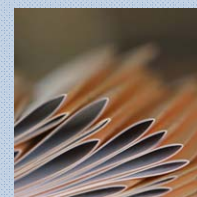


Canadian GAAP - IFRS Comparison Series

Issue 7 - Provisions



Both IFRS and Canadian GAAP are principle based frameworks, and from a conceptual standpoint, many of the general principles are the same. However, the application of those general principles in IFRS can be significantly different from Canadian GAAP. Therefore, to understand the magnitude of the differences between IFRS and Canadian GAAP, it is essential to look beyond the general principles and look at the detailed guidance provided in the standards. This is our seventh issue in a series of publications, which will provide detailed information on the key differences between IFRS and Canadian GAAP.

In this issue, issues regarding provisions, contingent liabilities and contingent assets will be presented, with focus on:

- Differences in recognition criteria;
- Differences in the measurement principles;
- Recognition and measurement of decommissioning liabilities (i.e. asset retirement obligations);
- Recognition of restructuring obligations; and
- Onerous contracts.

Be advised that this publication is a guide to the differences between Canadian GAAP and IFRS and is not meant to be a comprehensive manual. Please contact a BDO Dunwoody representative for specific details and information.

References

IFRS: IAS 37, Provisions, Contingent Liabilities and Contingent Assets, IFRIC 1 - Changes in Existing Decommissioning, Restoration and Similar Liabilities.

Canadian GAAP: Section 1000, Financial Statement Concepts, Section 3110, Asset Retirement Obligations, Section 3290, Contingencies, EIC 135 - Accounting for Costs Associated with Exit and Disposal Activities (Including Costs Incurred in a Restructuring).



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Key Definitions

The terminology differences between Canadian GAAP and IFRS lay the foundation for the differences in the accounting treatment. Canadian GAAP addresses the terms liability and contingency. It further breaks down contingency into contingent losses and contingent gains. IFRS addresses the terms liability, provisions, contingent liabilities and contingent assets. Understanding the differences in terminology is the key to understanding how obligations are treated under Canadian GAAP as compared to IFRS.

Canadian GAAP	IFRS
Liabilities are obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future.	Liabilities are a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of the entity's resources.
Canadian GAAP does not specifically define a provision.	Provisions are a liability of uncertain timing or amount. They are similar to contingent losses, which meet the recognition criteria under Canadian GAAP.
A contingency is defined as an existing condition or situation involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. Contingencies can be recognized and unrecognized.	<p>Contingent Liabilities are present obligations that do not meet recognition criteria as it is either not probable that an outflow of resources will be required to settle OR a sufficiently reliable estimate of the amount cannot be made. Contingent liabilities include only unrecognized obligations.</p> <p>A contingent asset is defined as 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 enterprise.</p>

Recognition Criteria

Under both Canadian GAAP and IFRS, an obligation is recognized depending on the likelihood of the outflow of resources to settle the obligation; and on the ability to reasonably determine the amount of the outflow. The decision tree in Appendix A provides guidance on the recognition criteria.

Canadian GAAP	IFRS
<p>Under Canadian GAAP, an obligation can either be legal, equitable or constructive. An equitable obligation is a duty based on ethical or moral considerations.</p> <p>A constructive obligation is one that can be inferred from the facts in a particular situation as opposed to a contractually based obligation.</p> <p>However, there are exceptions to this principle. In the case of an asset retirement obligation and restructuring costs, an obligation may be recognized only when there is a legal obligation to settle the obligation.</p>	<p>Under IFRS, an obligation can be either legal or constructive. A legal obligation refers to an obligation from a contract (explicit or implicit terms), legislation or other law.</p> <p>However, a constructive obligation is an expectation that is created by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities. As a result, the enterprise has created a valid expectation on the part of those other parties that will discharge those responsibilities.</p> <p>There are no exceptions to this principle as there is in Canadian GAAP.</p>
<p>Under Canadian GAAP, a contingent loss is recognized when it is likely that there will be an outflow of resources to settle the obligation. Likely is a higher recognition threshold than more likely than not.</p> <p>It should be noted that this is different than the general principles of Section 1000, where recognition is based on if it is probable that benefits will be obtained or given up.</p> <p>If an obligation exists but is not recognized, then it should be disclosed. The disclosure should include a description of the nature of the obligation and an estimate of the amount of the obligation or a statement that such an estimate cannot be made. Disclosures should also be made when the likelihood of occurrence of the future event cannot be determined; and for any exposure to loss in excess of the amount accrued.</p>	<p>Under IFRS, a provision is recognized when there is a probable outflow of resources to settle the obligation. Probable means more likely than not.</p> <p>Therefore, there is lower a threshold for recognizing such obligations under IFRS than under Canadian GAAP.</p> <p>If an obligation is not probable to result in an outflow of resources, it should be disclosed if a reliable estimate of the amount can be made.</p> <p>The disclosure requirements per IAS 37 are more extensive than under Canadian GAAP. Some of these disclosures include: movements in the provisions account for each class of provision; a description of the nature of the obligation and an estimate of its financial effect; information about any uncertainty regarding timing and amount of cash flows; and the possibility of any reimbursement.</p>
<p>Under Canadian GAAP, the amount of the loss must be reasonably estimable to be accrued.</p>	<p>Under IFRS, the standard takes the view that a sufficiently reliable estimate can always be made. In those very rare circumstances when it cannot be made, it would be disclosed as a contingent liability.</p>

Canadian GAAP	IFRS
<p>When it is likely that a future event will confirm that an asset had been acquired or a liability reduced at the date of the financial statements, the existence of a contingent gain should be disclosed in notes to the financial statements.</p> <p>Contingent gains are not recognized until they are realized.</p>	<p>Under IFRS, a contingent asset should be disclosed if it is probable that the economic benefits will be realized.</p> <p>A contingent asset is only recognized if it is virtually certain that it will be realized.</p>
<p>In Canadian GAAP, there is no specific recognition guidance provided for recoveries from third parties.</p>	<p>In some circumstances, a third party may reimburse part of the costs required to settle a provision or pay the amounts directly. The entity is usually liable for the whole amount if the third party doesn't settle. Therefore, a provision should be recognized for the whole amount. The reimbursement should only be recognized if realization is virtually certain.</p> <p>This may cause timing issues for recognition since the threshold for liability recognition (typically greater than 50%) is lower than the threshold for contingent asset recognition (typically greater than 95%). Therefore, the result is that a liability is recognized but the reimbursement is not.</p>

The table below summarizes the Canadian GAAP and IFRS recognition and disclosure requirements discussed above.

Likelihood of Outcome		Accounting Treatment	
IFRS	Canadian GAAP	Continent Liability / Loss	Contingent Asset / Gain
Virtually Certain > 95%	Virtually Certain > 95%	Recognize	Recognize
Probable 50% - 95%	Likely 70% - 95%	Recognize	Disclose
Possible 5% - 50%	Possible 5% - 70%	Disclose	No disclosure required
Remote < 5%	Remote < 5%	No disclosure required	No disclosure required

Other than the fact that probable is interpreted to mean more likely than not and therefore represents any percentage in excess of 50%, the other percentages presented above are to provide guidance and not be interpreted as bright lines.

Measurement

Canadian GAAP requires contingent losses to be based on a reasonable estimate, while IFRS requires the provision to be recognized at the best estimate. Although these sound like similar concepts, they are quite different.

Canadian GAAP	IFRS
<p>A reasonable estimate of the amount of a contingent loss to be accrued in the financial statements may be based on information that provides a range of the amount of loss. When a particular amount within such a range appears to be a better estimate than any other, that amount would be accrued; however, when no amount within the range is indicated as a better estimate than any other, the minimum amount in the range would be accrued.</p> <p>Disclosure of any exposure to loss in excess of the amount accrued would be made by way of notes to the financial statements.</p>	<p>A provision should be measured at an amount that is the best estimate of the expenditure required to settle the obligation at the balance sheet date. To put it another way, the provision should be measured at the amount an entity would pay a third party to relieve it of its obligation at the balance sheet date.</p> <p>The two measurement techniques used are expected value and net present value of the outflow.</p> <p>Expected value is used when a large population of items is being measured. A probability is assigned to each value and the sum of the probability weighted values equals the amount to be recognized.</p> <p>Where the effect of the time value of money is material, the amount of the provision should be recorded at the net present value of the expenditure required to settle the obligation. This could arise in the case of long term obligations where because of length of the term, the time value of money is material. When using net present value techniques the discount rate used should be pretax, and reflect the current market assessments of the time value of money. It should consider the risks specific to the entity. The standard does not provide specific guidance on how the requirements of discounting are to be applied or whether to use the real vs. nominal rate.</p>

Application of Key Concepts

Canadian GAAP	IFRS
Restructuring Costs	
<p>Under Canadian GAAP, EIC 135 provides guidance on the treatment of restructuring costs; however, it is less specific guidance than IFRS. It addresses contract termination costs and other costs that result from a restructuring. It prescribes that restructuring costs should be measured at fair value in the period in which the liability is incurred.</p>	<p>Under IFRS, a restructuring is a program that is planned and controlled by management, and materially changes either the scope of a business undertaken by an entity; or the manner in which that business is conducted.</p> <p>The costs that can be included in the restructuring provision should only include the direct expenditures arising from the restructuring, which are those that are both necessarily entailed by a restructuring; and not associated with ongoing activities of the entity.</p> <p>A restructuring obligation is recognized when it becomes a constructive obligation.</p>
Onerous Contracts	
<p>Under Canadian GAAP, future operating losses should not be recognized as a liability since they do not result from a past transaction. In addition there is no specific reference to onerous contracts in Canadian GAAP.</p>	<p>Under IFRS, provisions should not be recognized for future operating losses since they are not a present obligation resulting from a past event. However, onerous contracts are recognized as provisions. An onerous contract is a contract where the unavoidable costs of meeting obligations exceed the benefits.</p> <p>A provision is recognized based on the net cost to exit the contract. That is, the lower of the cost of fulfilling the contract and any penalties arising from failure to complete it.</p>

Canadian GAAP	IFRS
Asset Retirement Obligation	
<p>Under Canadian GAAP, an asset retirement obligation is recognized when there is a legally enforceable obligation.</p> <p>Changes resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows are recognized as an increase or a decrease in the carrying amount of the liability for an asset retirement obligation, and the related asset retirement cost capitalized as part of the carrying amount of the related long-lived asset.</p>	<p>Under IFRS, asset retirement obligations are referred to as decommissioning liabilities.</p> <p>A decommissioning liability is essentially a constructive or legal obligation to decommission the asset and / or restore the asset site to minimum required standards. It should be recognized if the likelihood of outflow of resources is probable and there is a reliable estimate of the amount to settle the obligation.</p> <p>As per IFRIC 1, changes in the measurement of an existing decommissioning, restoration or similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, shall be accounted for differently depending on the measurement model that was used for the related asset.</p> <p>If the related asset is measured using the cost model, then the changes in the liability should be added to or deducted from the cost of the related asset in the current period. The amount deducted from the cost of the asset should not exceed its carrying amount.</p> <p>If the related asset is measured using the revaluation model, then the change in the liability first grinds down any revaluation reserve and any remaining adjustment flows through profit and loss.</p>

The Future of Provisions and Contingencies under IFRS

In June 2005, the IASB issued an Exposure Draft proposing amendments to IAS 37. It is uncertain whether these amendments will be adopted before the changeover date of January 1, 2011. Based on the current IASB work plan, the revised standard is expected to be finalized in 2010, which seems to indicate a 2012 effective date. If finalized in 2010 with a 2012 effective date, Canadian entities will have to decide if they want to early adopt the new standard (if early adoption is permitted) or have another accounting change in 2012. From the feedback received on the exposure draft, the IASB is currently researching and debating the following issues:

- Distinguishing between a liability and business risk;
- Uncertainty about the existence of a present obligation (including constructive obligations);
- Whether all uncertainty about the outflow of economic benefits required to settle a liability can be reflected in measurement;
- Guidance on the building blocks of the expected value calculation;
- Lawsuits; and
- Disclosure of items that do not satisfy the current definition of a liability on the balance sheet.

Some changes regarding terminology, recognition and measurement are also being considered including:

- Terminology: remove terms “provision”, “contingent liability”, and “contingent asset” and replace with non-financial liabilities. Contingent assets will be referred to as reimbursement rights;
- Recognition: remove ‘probability’ criteria and consider issues around the uncertainty about the existence of a liability and using indicators (such as past performance) to determine whether a liability exists; and
- Measurement: best estimate guidance removed and replaced with ‘relief value’ which is the amount that an entity would pay a third party to relieve it of its obligation.

Conclusion

The principles related to provisions and contingencies under Canadian GAAP and IFRS have some similarities and some clear differences. In general the adoption of IFRS could result in additional liabilities being recognized.

If you require further guidance on provisions and contingencies under IFRS or any other IFRS information or reference sources, please contact your local BDO Dunwoody LLP office or visit www.bdo.ca/ifrs.

Appendix A: Decision Tree on Accounting Treatment for Provisions

