Provisions, contingent liabilities and assets

Supervision of Financial Reporting

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The Netherlands Authority for the Financial Markets (AFM)

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers’ and companies’ confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

1 Management summary

The AFM has investigated financial statements for 2012 with respect to the application of IAS 37, Provisions, contingent liabilities and contingent assets. The AFM decided to carry out this thematic review, because it expected that provisions would be necessary, mainly because of the ongoing economic crisis.

The AFM investigated 54 financial statements, and its observations are that:

- the provisions recognised usually have only a limited effect on financial position and performance;
- the disclosure requirements pursuant to IAS 37 have been properly applied;
- in 22 cases, the disclosure of contingent liabilities is perfunctory (use of 'boilerplate language');
- there is little or no mention of contingent assets in the disclosures.

Provisions usually have only a limited effect on financial position and performance
The provisions recognised amount to more than 5% of the total statement of financial position in only nine cases. The AFM did not find any financial statements in which the provisions were more than 10% of the total statement of financial position. Provisions released amounted to more than 5% of net profit in only five cases. The impact of provisions on the financial position and performance cannot therefore be described as large in most cases. The AFM's investigation did not assess whether the reporting rules for the recognition and measurement of provisions was correctly applied.

The disclosure requirements pursuant to IAS 37 have been properly applied
The majority of companies provide clear movement schedules for their provisions. More than half of them voluntarily include comparative figures for each type of movement. Elements such as the accounting policy, uncertainties and the timing of cash flows also appear in the disclosures. The disclosure is frequently less specific in cases where the provisions have less effect on the financial statements. The AFM is pleased to note that the disclosure requirements have in general been properly applied.

In 22 cases, the disclosure of contingent liabilities is perfunctory (use of 'boilerplate language')

The AFM encountered a disclosure of contingent liabilities in 49 financial statements. In 22 cases, this disclosure appears to be provided merely to satisfy an obligation, and no actual information is given regarding the company-specific aspects of the liabilities in question. The AFM would like to see more company-specific elements in these disclosures, as this would increase their relevance.

Little or no mention of contingent assets in the disclosures

It is notable that contingent assets (such as legal proceedings initiated by the companies) are only mentioned in 5 out of 54 financial statements investigated. In the other 49 cases, the AFM found no disclosure of contingent assets. We consider it likely that more companies actually have contingent assets, in which case this should be disclosed.

2 Rationale, objectives and population

2.1 Rationale

In times of financial uncertainty, provisions in the financial statements appear to become more significant. Taking account of probable future expenses if the company has a liability is permitted. The question of whether a provision should be formed requires very careful consideration by the company management. The reporting standard for provisions (IAS 37) includes a number of requirements for the disclosure of provisions that are intended to prevent the risk of excessive influence on the result. A company must therefore include a movement schedule in its financial statements for each category of provisions. A company must also describe the nature of the provision, as well as the uncertainties with respect to the amount and timing of the potentially associated outgoing cash flows.

2.2 Objective: transparency

The thematic investigation of the application of IAS 37 is designed to evaluate the degree of transparency with respect to provisions, contingent liabilities and contingent assets on the basis of the disclosure requirements of IAS 37. Companies are encouraged to improve the quality of their financial statements on this point where necessary. The investigation was not designed to assess whether the reporting requirements for the recognition and measurement of provisions were correctly applied.

2.3 Population: 54 companies

In the design of the thematic review, we decided to include all companies featured in the AEX, AMX and AScx indices, to the extent that their financial reporting falls under our supervision. We omitted financial institutions from the population, as the standards dealing with financial instruments (IAS 32, IAS 39 and IFRS 7) and insurance contracts (IFRS 4) are much more important than IAS 37. This brings us to a total population of 54 companies.

3 Key review results

3.1 Provisions usually have only a limited effect on financial position and performance

The effect of the item of provisions on the total financial position, net profit and equity is limited. The provisions recognised amount to more than 5% of the total financial position in only nine cases, and the AFM did not encounter any financial statements in which provisions amounted to more than 10% of the total financial position. The effect of provisions on net profit is also limited. The movement in provisions amounted to more than 5% of net profit in fourteen cases, and the release from provisions exceeded this percentage in only five cases.

The effect of provisions is slightly greater with respect to equity: 26 out of 54 companies recognised provisions that exceeded 5% of their equity. In four cases the provisions recognised amounted to more than 25% of equity, however this concerns companies with a relatively high degree of leverage; the equity of these four companies amounts to not more than 15% of their total financial position.

Five companies did not report any provisions at all. One of these companies is in the AMX index, and the others belong to the AScx. In one case, the reporting of no provisions (for instance, with respect to guarantees) would not appear to be consistent with the company's activities (goods delivery).

The AFM notes that the item of provisions is not particularly significant in most of the cases investigated. The importance of this item to users is therefore also limited in most cases. The findings we detail below should therefore be viewed in that light. The AFM's investigation did not assess whether the reporting requirements for the recognition and measurement of provisions were correctly applied.

3.2 The disclosure requirements pursuant to IAS 37 have been properly applied

The majority of companies provide clear movement schedules for their provisions. In only two cases, no distinction was made between the use of a provision and the release of a provision. This reduces transparency with regard to the appropriation, use and necessity of the provision. More than half the companies report comparative figures for each type of movement in addition to the mandatory movement schedules. Comparative figures are not mandatory under IAS 37. All the companies present comparative figures for each provision at year end. Elements such as the accounting policy, uncertainties and the timing of cash flows also frequently appear in the disclosures. In general, the detail in the disclosures depends on the importance of the specific provision. The AFM is pleased to note that the disclosure requirements have been properly applied.

3.3 In 22 cases, the disclosure of contingent liabilities is perfunctory (use of ‘boilerplate language’)

The AFM encountered a disclosure of contingent liabilities in 49 financial statements. In 22 cases, the text provided was relatively standard in nature. The fact that a company may become involved in legal disputes with customers in the normal course of its business is an example of a very general description. The AFM would like to see more company-specific elements in these disclosures, since this would increase their relevance. 27 companies already provide this kind of detail. The AFM is pleased to note that some disclosures clearly state the matter in question, the management’s expectations and the reasons for the decision not to form a provision.

3.4 Little or no mention of contingent assets in the disclosures

Only five companies report contingent assets. This item mostly relates to current legal proceedings that companies have initiated. On the basis of the disclosures provided, recognition of a contingent asset would seem to be appropriate. The AFM considers it remarkable that no contingent assets are recognised in 49 out of 54 financial statements it investigated. We consider it likely that more companies actually have contingent assets, in which case this should be disclosed.

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