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RESERVES IN TRADITIONAL AND CONTEMPORARY ACCOUNTING

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ABSTRACT

The main aim of the article is to analyse concepts of reserves in traditional accounting models and the characteristics of the area of reserves in contemporary global accounting standards.

Concepts of reserves in different countries are deeply rooted in the socio-economic environment of accounting. The differences in the significance, role and the scale of creation of reserves are especially evident in the Anglo-Saxon and continental accounting

Reserves play a very important role in the accounting system of IFRSs– they provide a specific control mechanism which enables companies to verify economic benefits embodied in their net assets.

The analysis of the IFRSs rules concerning the creation of valuation reserves and provisions may lead to the conclusion that they are- above all – subject to true and fair view concept. The only purpose of reserves is to present faithfully the estimated loss in value of net assets. There are many requirements which are intended to prevent the undue use of reserves.

The area of reserves is becoming more and more complex. The sources of complexity of reserves go beyond their inherent features and stem from the general orientation of contemporary accounting towards a model of anticipated losses/gains in net assets.

JEL CLASSIFICATION & KEYWORDS

■ M41 ■ RESERVES ■ VALUATION RESERVES ■ PROVISIONS

INTRODUCTION

The main aim of the article is to analyse concepts of reserves in traditional accounting models and the characteristics of the area of reserves in contemporary global accounting standards.

For the purpose of the article reserves are treated as an accounting category comprising provisions, valuation reserves and capital reserves[1].

Provisions are intended to cover the debts the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise. Provisions are specific liabilities. An essential characteristic of a liability is that the entity has a present obligation arising from past events. The settlement of a present obligation involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Liabilities include those obligations which are absolutely certain as to the timing and amount and those which cannot be determined with such a certainty. The latter are usually described as provisions.

Apart from provisions, reserves also include valuation reserves. Valuation reserves are not probable liabilities of an entity but are connected with the changes of values of economic resources controlled by the company. The book value of assets is reviewed at the end of each accounting period and adjusted to provide a reliable valuation of entity's economic resources. Valuation reserves indicate the difference between carrying amount and realizable value of assets.

Provisions and valuation reserves are recognized in profit (loss) for the period. By means of this procedure economic resources of an entity are "set aside" in order to meet expected obligations to third parties or to rebuilt the decreased value of assets.

The third group of reserves - capital reserves include legal and statutory reserves. The main source of capital reserves are the retained earnings.

The main premise of all reserves is uncertainty accompanying actions taken by an enterprise. By presenting the impact of risk on financial position of the company, reserves enable to comply with the true and fair view concept and to retain resources within the company to balance the estimated loss in value of net assets and therefore play a fundamental role in the capital maintenance.

Reserves in traditional accounting models

Reserves have been present in accounting since the development of double-entry bookkeeping. The double-entry system was developed by Italian merchants and bankers in the Middle Ages. The account-books that are still preserved reveal that it was a standard policy of medieval companies to set up reserves for accrued wages, bad debts, and unforeseen contingencies before dividing any profits.

The oldest records of reserves were found in the account-books of Perruzzi (1300–1343) and Alberti (1302–1348) (de Roover, 1956, p.128; de Roover, 1958, pp. 32–34; Melis, 1962, p. 402). Plenty examples of reserves were also found in the account-books of two famous medieval companies – Datini and Medici (de Roover, 1956, pp. 142–144,153,154).

Until the beginning of XXth century recognition of reserves had become a common practice.

However, in the course of time, different countries elaborated individual concepts of reserves. These concepts were deeply rooted in the socio-economic environment of accounting.

The differences between concepts of reserves are clear – cut in two traditional models of accounting – continental and Anglo-Saxon accounting. The ideas and rules in the area of reserves implemented in the above models will be analyzed on the basis of German and American accounting.

[1] The area of reserves is full of linguistic difficulties. This category may be referred to as "reserves", "provisions", "allowances", "value adjustments". On the one hand, different terms may be used to describe the same groups of reserves - for example the word provision may be used to mean liabilities of uncertain amount or timing and a reduction in the value of assets. On the other hand the same group of reserves may be described differently. For example liabilities of uncertain amount of timing in UK English are called provisions, while in American English in this case words – "provision" and "reserve" are used interchangeably.
In the article the following words will be used:
- provisions/ reserves – to describe liabilities of uncertain amount or timing,
- valuation reserves/ reserves- to describe value adjustments,
- capital reserves for reserves in equity section.

Among the factors of the socio-economic environment which have great influence on accounting, the financial system is usually mentioned as the most important one. Financial systems are often grouped into two types – capital market systems and credit based systems. In the United States and in the United Kingdom, companies raise their capital among numerous shareholders on large equity markets. By contrast, in countries like Germany, France, Italy companies rely heavily on bank credits. Although, to some extent, financial systems in the above countries are evolving by adapting elements of both types of financial systems, the differentiation between equity and credit countries is still clear (Nobes, Parker, 2012, pp. 32-35).

Accounting regulations and practices develop to a large extent to satisfy the information needs of those who provide capital. Countries with large equity markets need financial reporting suited to disclosing useful information to investors. Other countries have accounting linked to the distributable income and calculation of taxable income (Nobes&Parker, 2012, p. 51). In Germany capital is provided mainly by banks. Therefore, the main objective of financial reporting in Germany is to prevent any erosion of the capital through a conservative determination of profit, assets and liabilities, motivated by the need to protect creditors (Ballwieser, 2001, p. 1223; Haller&Eierle, 2004, p. 36).

Thus, the overriding principle of continental accounting is the principle of conservatism. Consequently, according to German regulations (Seckler&Voss, 2003, p. 7.06 – 7.07):

- values must be determined prudently, that is, all anticipated risks and losses that arise up to the balance sheet date are to be recognized, even if they become known only after the balance sheet date but before the financial statements are prepared; profits may be recognized only if they are realized (realization and imparity principle);
- valuation of assets is based on historical cost, it is not allowed to use fair value that exceeds historical cost;
- provisions for liabilities and valuation reserves can be set up if it is possible, but not necessarily probable, that an asset has been impaired or a liability has been incurred.

It is assumed that a company exists for the long run and the capital of the company should be preserved. In order to preserve the capital it is necessary to pay attention to the careful determination of distributable income. In continental accounting this idea is realized through a prudent calculation of profits and additional restrictions on the distribution of profits. In achieving this goal all groups of reserves play a very important role.

German regulations enable companies to create reserves on a very large scale.

First, there is an extensive list of reserves that can be created. Provisions can be set up not only when there is an obligation arising from past events. They also cover the charges to be incurred in the future. For example, provisions are required for repairs and maintenance expenses to be incurred within the first three months of the following year. Provisions may also be set up for repairs and maintenance carried out after the first three months but before the end of the following financial year, and for certain periods in respect of expenses for which a necessity will arise over a longer period, such as major repairs (Nobes &Parker, 2012, p. 360).

Provisions, as well as valuation reserves, can be recognized even if the probability that an asset has been impaired or a liability has been incurred is remote.

Moreover, the amount recognized as a reserve is usually the highest amount in the range of possible outcomes.

Reserves are used not only to compute the profits on a very prudent basis but also in order to eliminate potential fluctuations of earnings in subsequent periods. Companies set up reserves in good years and reverse them in bad years. It is assumed that the stable pattern of profits is – apart from its prudent calculation – an inevitable precaution taken for the sake of creditors and the existence of the company for the long run.

In this battle for stable profits companies also use secret reserves which are a result of an intentional understatement of assets and revenues or overstatement of liabilities and expenses.

Apart from prudent calculation of profits (which is achieved mainly by a heavy use of provisions and valuation reserves) the capital of companies is additionally protected by restrictions on the income distribution – in this case the third group of reserves – capital reserves play a very important role.

In Germany some companies are required to create legal reserves. Five per cent of net income for the year must be allocated to the reserves until the legal reserves and capital reserves (excluding other capital contributions by shareholders) together equal 10 per cent of the nominal capital or such higher amount as is provided in articles (Nobes&Parker, 2012, p. 357).

It's worth noting, that in German regulations little emphasis is put on obligatory disclosure on reserves. The lack of extensive information in the financial statement is a rather general feature of continental accounting, which is often explained by the fact that the main suppliers of capital – bank creditors can communicate directly with the company, thus not much attention is given to public reporting of information (Joos&Lang, 1994, pp. 144,145).

The vast use of reserves in accounting in continental countries can also be attributed to a strong uncertainty avoidance of continental societies. It is believed that "it is better to protect a company against risk even if that means that income is understated, and the financial statement doesn't report a true and fair view of financial position of a company" (Russocki, 2001, p.47).

Some authors say that such attitude may lead not only to the creation of reserves which are justified by the existence of a risk in the company, but above all- to the creation of reserves which can be easily questioned as bearing no relation to reality (Surdykowska, 1999, p. 262).

The Anglo-American model of accounting represents a completely different approach towards reserves.

The heavy reliance of American companies on the stock market for capital has resulted in a strong emphasis on published financial information for the use of investors.

According to the American Conceptual Framework for Financial Accounting and Reporting the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit (SFAC No. 8 – Conceptual Framework for Financial Reporting, par. OB2).

Having in mind the most important objective of financial reporting – providing useful information to investors,

American Financial Accounting Standards Board (FASB) calls for a very careful use of conservatism in accounting. While describing qualitative characteristics of accounting information (SFAC No. 2 – Qualitative Characteristics of Accounting Information) the Board acknowledges that there is a place for a convention such as conservatism in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference "that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets" introduces a bias into financial reporting, conservatism tends to conflict with significant qualitative characteristics of financial reporting such as representational faithfulness, neutrality, and comparability (SFAC No. 2 – Qualitative Characteristics of Accounting Information , par. 92). According to the Board conservatism in financial reporting shouldn't lead to deliberate, consistent understatement of net assets and profits. Moreover, conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred. Any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run (SFAC No. 2 – Qualitative Characteristics of Accounting Information, par. 93-97).

In the Concept Statement which replaced SFAC No. 2 in September 2010 FASB takes a definite stand on the matter of conservatism – the conservatism or prudence is not included "as an aspect of faithful representation because including either would be inconsistent with neutrality" (SFAC No. 8 – Conceptual Framework for Financial Reporting, par. BC3.27).

Following the above attitude towards conservatism, American regulations do not allow companies to set up reserves on such a large scale as in Germany.

Firstly, reserves can be recognized only if specific conditions are met. An estimated loss from a loss contingency (connected with the impairment of an asset or incurrence of a liability) can be accrued by a charge to income only if:

- information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements, and
- the amount of loss can be reasonably estimated (FASB Statement of Financial Accounting Standards No. 5 – Accounting for Contingencies, par. 8) .

Usually a much bigger degree of probability is required to recognize a reserve compared to German regulations. According to American accounting standards (SFAS No. 5 – Accounting for Contingencies, par. 3,8) when a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. Three areas are identified within that range – probable (the future event or events are likely to occur), reasonably possible (the chance of the future event or events occurring is more than remote but less than likely), remote (the chance of the future event or events occurring is slight). It should be noted that reserves can be created only when the loss contingency is probable.

Secondly, whereas in continental accounting reserves are usually recognized in the highest amount in the range of possible outcomes in American standards the measurement of reserves is based on the rule of reasonable estimate which can be summarized as follows: when some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued (FASB Interpretation No. 14 – Reasonable Estimation of the Amount of a Loss, par. 3).

Reserves are not seen as a tool of deliberate understatement and stabilization of net assets and profits. "The sole result of accrual, for financial accounting and reporting purposes, is allocation of costs among accounting periods" (SFAS No. 5 – Accounting for Contingencies, par. 63).

Reserves shouldn't be used to avoid reporting profits that fluctuate from period to period. The improper use of reserves (for example the accrual of a reserve without regard to whether the loss relates to the current period if, based on experience, it is reasonable to expect losses sometime in the future) may distort the picture of a real financial situation of the company. "If the nature of an enterprise's operations is such that irregularities in the incurrence of losses cause variations in periodic net income, that fact should not be obscured by accruing for anticipated losses that do not relate to the current period" (SFAS No. 5 – Accounting for Contingencies, par. 64).

Adequate disclosure must be made of reserves. For each class of provision, an enterprise should disclose the amount of the provision, a brief description of the nature of obligation, major assumptions made concerning future events. Similar disclosures must accompany loss contingencies connected with the impairment of assets (SFAS No. 5 – Accounting for Contingencies, par. 9–11).

Anglo-Saxon accounting and continental accounting differ not only in the attitude to provisions and valuation reserves but also in relation to capital reserves.

Contrary to Germany, there are no legal reserves in Unites States (Nobes&Parker, 2012, p. 216).

Reserves in International Financial Reporting Standards

The globalization of the world's economy has forced the necessity of harmonization and standardization of accounting. From the 1970s a number of bodies were working on narrowing the differences in the financial reporting practices of companies in different countries. Nowadays, the harmonization is led by the International Accounting Standards Board (IASB) which main objective is to develop a single set of global accounting standards. International Financial Reporting Standards (IFRSs) issued by the IASB were adopted by many countries around the world and have become the worldwide model of accounting.

The accounting of International Financial Reporting Standards stems from Anglo-Saxon tradition. The scope as well as the significance of reserves in IFRSs are strictly connected with the most important aim of Anglo-Saxon accounting which is the decision usefulness.

There is no doubt that valuation reserves and provisions play a very important role in the accounting system of IFRSs – they provide a specific control mechanism which enables companies to verify economic benefits embodied in their net assets.

By creating valuation reserves entities ensure that their assets are carried at no more than their recoverable amount. According to the IFRSs (IAS 36 – Impairment of Assets, par. 1) an asset is carried at more than its recoverable amount

if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the standards require the entity to recognise an impairment loss.

The starting and the most important point in the procedure of the recognision of an impairment loss is the analysis of indications that an asset may be impaired.

In assessing whether there is any indication that an asset may be impaired, an entity should consider both external and internal sources of information.

If there are indications of asset's impairment an entity should proceed to the next step of procedure – the determination of recoverable amount of an asset.

IFRSs define recoverable amount as the higher of an asset's fair value less costs to sell and its value in use[2].

If, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss. An impairment loss shall be recognised immediately in profit or loss or (if an asset is carried in revaluation amount) should be treated as a revaluation decrease (IAS 36 – Impairment of Assets, par. 59, 60).

By creating provisions entities ensure that all liabilities are included in the financial statement. According to IFRSs, a provision is a liability of uncertain timing or amount. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, par. 10.).

A provision should be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation (IAS 37 - Provisions, Contingent Liabilities and Contingent Assets, par. 14) .

If these conditions are not met, no provision should be recognised.

Provisions should be distinguished from accruals and contingent liabilities. Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately. Contingent liabilities are either possible obligations which will be confirmed by uncertain future events, or present obligations which are not recognized by the entity because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or the amount of the obligation cannot be measured with sufficient reliability (IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, par. 11–13).

The analysis of the IFRSs rules concerning the creation of valuation reserves and provisions may lead to the conclusion that they are – above all – subject to true and fair view concept (Klimczak, 2011. pp. 283–298).

The only purpose of reserves is to present faithfully the estimated loss in value of net assets. There are many requirements which are intended to prevent the undue use of reserves.

In case of valuation reserves, as it was mentioned before, the heart of the whole procedure lies in the individual analysis of the indications of impairment. The role of this analysis is enhanced by the fact that if there are no indications of impairment it's not necessary to implement the rest of the procedure.

Once the entity has found the indications of asset's impairment there are strict rules and limitations on measuring and recording impairment loss.

According to these rules:

- it is assumed that asset has been impaired only when both levels of recoverable valu,
- (asset's fair value less costs to sell and its value in use) are less than the carrying amount – if either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount,
- when both levels of recoverable amount are less than carrying amount an impairment,
- loss has to be recognized and the value of an asset is reduced,
- the amount of reduction is limited only to the difference between carrying amount and
- the higher level of recoverable value (IAS 36 – Impairment of Assets, par. 18,19) .

Strict rules and procedures are also prescribed by IFRSs for provisions.

Firstly, the provision can be created only when there is an obligation (IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, par. 10, 17, 18, 19).

An obligation exists when the entity has no realistic alternative to settling the obligation. This situation takes place when an obligation:

- can be enforced by law (legal obligation) or is created by entity's actions (constructive obligation),
- arises from past obliging event,
- exists independently of an entity's future actions.

Secondly, the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. According to IASB "the risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities." (IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, par. 36–38, 42, 43).

Thirdly, only direct expenditures that are closely related to the event causing the obligation can be recognized as a provision. For example a restructuring provision can include only the direct expenditures arising from the restructuring, which are those that are both necessarily

[2] *Fair value less costs to sell* is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. *Value in use* is the present value of the future cash flows expected to be derived from an asset (IAS 36 – *Impairment of Assets*, par. 6).

entailed by the restructuring and not associated with the ongoing activities of the entity. A restructuring provision does not include such costs as retraining or relocating continuing staff, marketing, investment in new systems and distribution networks. These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring (IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, par. 80, 81).

Moreover, a provision can be used only for expenditures for which it was originally recognised. According to the IFRSs setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events (IAS 37 - Provisions, Contingent Liabilities and Contingent Assets, par. 61, 62).

Much attention is given to the review of reserves at the end of each accounting period.

Companies have to assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset may no longer exist or may have decreased. An impairment loss recognised in prior periods for an asset should be reversed if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. A reversal of an impairment loss for an asset is recognised immediately in profit or loss or treated as a revaluation increase (in case of revalued asset) (IAS 36 – Impairment of Assets, par. 110, 119).

Also provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision must be reversed. (IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, par. 59, 60).

Much stress is put on the proper disclosure on reserves. For assets an entity should disclose the amount of impairment losses and reversals of impairment losses recognised during the period (IAS 36 – Impairment of Assets, par.126.)

For provisions an entity should disclose, among others:

- the amount of provisions at the beginning and end of the period, additional provisions made in the period (including increases to existing provisions), amounts used (incurred and charged against the provision) during the period, unused amounts reversed during the period;
- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits together with an indication of the uncertainties about the amount or timing of those outflows (IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, par. 84,85) .

The above deliberations relate to two groups of reserves – provisions and valuation reserves. The third group of reserves – capital reserves are not addressed at IFRSs. However, it is noted that the creation of these reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effects of losses. The information about the existence and size of these reserves can be relevant to the decision-making needs of financial information users (The Conceptual Framework for Financial Reporting, par. 4.21).

Current developments in valuation reserves

Among different projects connected with the measurement of assets undertaken by the IASB the problem of financial instruments seems to be the most interesting in context of the article.

In November 2009, the IASB published an exposure draft – Financial Instruments: Amortised Cost and Impairment (Exposure Draft ED/2009/12 – Financial Instruments: Amortised Cost and Impairment) – proposing a new approach to the impairment of financial assets measured at amortised cost.

The proposals in this exposure draft would replace the amortised cost (including impairment) requirements in IAS 39 for financial instruments[3].

The current impairment model under IFRSs is an incurred loss model. Credit losses of financial assets measured at amortised cost are recognised only if there is objective evidence of impairment as a result of a loss event that occurred after initial recognition of the financial asset and the effect of that loss event on the future cash flows can be reliably estimated. Expected future credit losses are not permitted to be recognised until a (loss) event has occurred.

The global financial crisis revealed significant weaknesses of the incurred loss model. The incurred loss approach has been criticized for many reasons, mainly because:

- expected losses are recognized too late (which creates misleading information deficiency),
- the interest revenue in the periods before a loss event is systematically overstated (contractual interest is recognised as revenue),
- subsequent impairment losses are in fact (at least partially) reversals of inappropriate revenue recognition in earlier periods,
- the recognition of the impairment after the loss event results in an abrupt adjustment in income statement,
- impairment loss is recognized after the loss event even if the amount of that loss had always been expected (based on historical experience),
- the current model assumes that the loan will be paid in full unless at some point in future it comes out that it's not possible, which is not consistent with how entities make lending decisions – when a loan is made, the risk

[3] The draft is a part of a wider project to reform accounting for financial instruments.
The financial crisis had a great impact on this area of accounting – large pressure was put on accounting standards-setters, especially on IASB to fundamentally reconsider the accounting and reporting for financial instruments. In 2009 the IASB announced a plan to replace the existing financial instruments accounting standard with a new standard IFRS 9 – Financial Instruments. The project is divided into three phases:
classification of financial assets and financial liabilities, amortised cost and the impairment of financial assets,
hedge accounting. First phase is completed. IFRS 9 Financial Instruments was published in November 2009 (initially it specified requirements for the classification of financial assets) and expanded in October 2010 (the classification of financial liabilities was added). The second and third steps of the project are ongoing. In November 2009, the IASB published a separate exposure draft – Financial Instruments: Amortised Cost and Impairment (Exposure Draft ED/2009/12 – Financial Instruments: Amortised Cost and Impairment). In December 2010 the IASB published an exposure draft of a proposed general hedge accounting model that significantly reduces the complexity associated with hedge accounting and improves the information provided about risk management activities (Exposure Draft ED/2010/13 – Hedge Accounting).

of default is included in calculating the interest on the loan,

- current model is also inconsistent with the risk management of many financial institutions (which takes into account the effect of credit loss expectations),
- the model undermines the comparability of financial information (it's not always clear when the loss event takes place- in practice entities use different loss events to recognize the impairment) (Basis for Conclusions on Exposure Draft ED/2009/12 - Financial Instruments: Amortised Cost and Impairment, par. BC 10-BC13).

After considering alternative impairment approaches (impairment based on fair value and "through-the-cycle" approaches, including "dynamic provisioning") the IASB decided to propose an expected loss approach to determining impairment. The proposals would require an entity to determine the expected credit losses on a financial asset when that asset is first obtained. Initial estimate of the expected credit loss will be included in determining the effective interest rate. Therefore, the initial estimate of the expected credit losses would be allocated over the expected life of the financial asset (Exposure Draft ED/2009/12 – Financial Instruments: Amortised Cost and Impairment, par.6-10; Basis for Conclusions on Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment, par. BC25).

The exposure draft requires special disclosures about amounts presented in the statement of comprehensive income, inputs and assumptions used for determining credit loss estimates, and the quality of financial assets measured at amortised cost (Basis for Conclusions on Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment, par. BC52).

In particular, the statement of comprehensive income should present more disaggregated information, by including following items:

- gross interest revenue (calculated using the effective interest method before taking into account the allocation of the initial estimate of expected credit losses),
- the portion of initial expected credit losses allocated to the period, which shall be presented as a reduction of gross interest revenue,
- net interest revenue,
- gains and losses resulting from changes in estimates in relation to financial assets and liabilities that are measured at amortised cost,
- interest expense (calculated using the effective interest method) (Exposure Draft ED/2009/12 – Financial Instruments: Amortised Cost and Impairment, par.13).

What's more, in order to improve the quality and comparability of information entities will no longer be allowed to record direct write-offs against the contractual amount of financial assets (currently the carrying amount of the asset can be reduced either directly or through use of an allowance account). Under the exposure draft entities are required to use allowance account to account for credit losses. In addition, entities shall disclose for each class of financial assets a reconciliation of changes in that account during the period and their write-off policy (Exposure Draft ED/2009/12 - Financial Instruments: Amortised Cost and Impairment, par.15).

The new approach will result in an earlier recognition of credit losses. Although there are many potential benefits of a new approach (improved information about credit quality of assets, enhanced transparency regarding interest revenue and credit losses) it also entails many problems (Basis for Conclusions on Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment par. BC 26, 29; Snapshot: Supplement to the Exposure Draft Financial Instruments: Amortised Cost and Impairment, p.3,4).

According to the opinions of observers it would present some operational difficulties. The implementation of a new approach would require to combine the information from accounting system (which calculates interest rates that determine interest revenue) and risk management systems (which monitor expected losses). As in practice these systems are usually maintained separately, necessary changes would have to be made. This process may be costly and take long time. Another drawback of the new approach is the operational complexity. Under this approach it's necessary to estimate expected losses and the time of such losses (on individual or portfolio basis). For large and complex portfolios this may be a difficult challenge[4].

Current developments in provisions

In June 2005, the IASB published an exposure draft of a standard to replace IAS 37 Provisions, Contingent Liabilities and Contingent Assets (Exposure draft of proposed amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits).

After a long period of deliberation (in January 2010) the Board issued a second exposure draft "Measurement of Liabilities in IAS 37" (Exposure Draft ED/2010/1 – Measurement of Liabilities in IAS 37). In February 2010 a working draft of the proposed new IFRS "Liabilities" was published (Working draft 19 February 2010 – International Financial Reporting Standard [X] – Liabilities).

The draft includes the original proposals from the exposure draft 2005 with further amendments identified by the Board during its deliberations on the project and the exposure draft on measurement of liabilities (Baltazar et al., 2012, p.1761).

The most important solutions set out in the draft can be briefly summarized as follows.

Firstly, the standard sets out rules of recognition, measurement and disclosure not only for provisions but for all liabilities, except those within the scope of another

[4] The IASB is still working on the project. To overcome potential operating difficulties it proposed separating the calculation of interest rates from the recognition of expected losses. Instead of calculating the effective interest rate after considering all expected cash flows including expected credit losses, the entities could continue to calculate the effective rate as required by IAS 39 and then then use separate approach for allocating expected credit losses over the life of financial assets. In addition, to simplify the allocation mechanism for credit losses, the Board proposed the differentiation of financial assets managed on an open portfolio basis into two groups for the purpose of determining the impairment allowance. For the 'bad book' assets (assets which are considered problematic), expected losses should be recognized immediately. For the 'good book' assets (assets which are not considered problematic) expected losses should be recognised over time, using a 'time-proportional' approach (Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment, BC 34-36). Later (in June 2011) the IASB introduced a model which splits loans subject to impairment accounting into 3 main categories ('buckets') which determine the timing and amount of credit losses to be recognized (Staff Paper-IASB/FASB Meeting, June 2011). The Board continues its discussion on the proposed impairment model (IASB Meeting Summary, November 2012).

standard and those resulting from executor contracts, unless the contract is onerous.

The draft doesn't use the term provision, but it also doesn't prescribe the terms that entities should use to describe their liabilities. Therefore entities may continue to describe some classes of liabilities as provisions in their financial statements (it's not prohibited by the draft).

According to new rules, an entity shall recognise an item as a liability if the item meets the definition of a liability and it can be measured reliably. At present, IAS 37 specifies three criteria that must all be satisfied before an entity recognises a liability. Compared to the existing standard the new IFRS doesn't include the probability recognition criterion (which requires entities to recognize liabilities only if it is probable that an outflow of resources will be required to settle the obligation). Instead, an entity should account for uncertainty about the amount and timing of outflows by using a measurement that reflects their expected value, ie the probability-weighted average of the outflows for the range of possible outcomes.

The project eliminates the term contingent liability. It's consistent with the idea that liabilities arise only from unconditional (or non-contingent) obligations. Hence, something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event doesn't itself give rise to a liability (Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets - Project Update, June 2007).

Many items previously described as contingent liabilities can be analysed as two obligations: un unconditional and conditional obligation. The first one establishes the liability and the second one affects the amount that will be required to settle the liability. Consequently, the IASB applies the concept of "stand ready obligation".

The standard contains liabilities measurement rules. Entity should measure a liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation. The amount to be paid is interpreted as the lowest of:

- the present value of the resources required to fulfill the obligation; and
- the amount that the entity would have to pay to cancel the obligation; and
- the amount that the entity would have to pay to transfer the obligation to a third party.

According to new rules all obligations (large populations of liabilities, as well as single obligations) should be measured using the weighted average of the possible outcomes, ie "expected value".

The standard specifies which costs should be included in the measurement of obligations fulfilled by making payments to the counterparty and obligations which will be fulfilled by undertaking a service at a future date. In the first case, the liability includes payments to the counterparty and associated costs, such as external legal fees or the costs of an in-house legal department attributable to that obligation. If the obligation is fulfilled by undertaking a service the measurement of a liability should be based on the amount that the entity estimates a contractor would charge at the future date to undertake the service on the entity's behalf (if there is a market for a service). If there is not a market for the service, the entity estimates the amount it would charge another party at the future date to undertake the service (the estimates shall include the costs the entity expects to incur and the margin it would require to undertake the service for the other party).

Apart from general rules for all liabilities the standard includes some changes concerning specific liabilities – for example the liabilities arising from onerous contracts or restructuring.

For liabilities arising from onerous contracts the draft proposes an additional criterion of recognition. If a contract becomes onerous as a result of entity's own action the entity shall not recognise a liability for the onerous contract until it has taken the action.

The standard introduces a new approach towards restructuring costs. Currently entities record a liability for the total costs of restructuring a business when they announce or start to implement a restructuring plan. The new IFRS will require an entity to record a liability for each individual cost of a restructuring only when that particular cost is incurred.

The main objectives of the IASB project on provisions was to align the recording of liabilities with other IFRSs, support global convergence of financial reporting standards and to improve measurement of liabilities. It's worth noting, that from the beginning the project has become a subject of much controversy. Observers and commentators are mainly concerned about (Staff Paper, Liabilities – IFRS to replace IAS 37, 16 November 2010; Staff Paper, Liabilities – IFRS to replace IAS 37, September 2010):

- the removal of the 'probable outflows' recognition criterion, and
- the requirements of measurement of liabilities.

According to many respondents the removal of the probable outflow criterion will lead to the recognition of liabilities that will probably not result in an outflow of benefits which does not provide relevant information to investors and imposes additional burdens on preparers. Moreover, the probable outflows criterion is a useful practical filter that avoids the need for complicated judgments about whether a liability exists (Staff Paper, Liabilities – IFRS to replace IAS 37, 16 November 2010).

Another issue which raises many concerns is the measurements of liabilities. There is a strong opposition against the use of expected values to all obligations.

According to respondents the use of expected value measurements for single liabilities:

- doesn't not provide users with relevant information (measurements of the most likely future outflows – along with disclosure of other outcomes – are more relevant),
- can be unreliable (when entities cannot rely on historical experience it's very difficult to estimate reliably the expected values of liabilities),
- will require more costly and complex processes and systems and would outweigh any potential benefits) (Staff Paper, Liabilities – IFRS to replace IAS 37, September 2010).

Moreover, many respondents disagree with the 'lowest of' criterion for establishing the amount that would rationally be paid to be relieved of a present obligation. They think that liability measurements should reflect the intended method of settlement. Entities might not always choose the lowest cost settlement route. In such circumstances, measurements of the lowest amount would not provide

relevant information. A requirement to measure the liability by reference to the intended method of settlement would also avoid the need to identify three different measurements (Staff Paper, Liabilities – IFRS to replace IAS 37, September 2010).

Another proposal which is criticized by many respondents is the measurement of liabilities to perform services at a contractor price. They argue that contractor prices do not represent real future cash flows but include hypothetical margins that 'distort' the income statement and tell users little about the underlying profitability of the business (Staff Paper, Liabilities – IFRS to replace IAS 37, September 2010).

Conclusion

Reserves are a permanent and fundamental category, which has been present in accounting since the development of double-entry bookkeeping. With time different countries elaborated different concepts of reserves - the significance of reserves, as well as the scale on which they are created are deeply rooted in the socio-economic environment of accounting.

In the accounting of global international standards reserves play a very important role – they enable entities to present their net assets faithfully. IFRSs set out specific conditions of recognition, measurement and disclosures on reserves.

There is no doubt, that the area of reserves is becoming more and more complex.

First, complexity seems to be the natural feature of reserves. Main attributes of reserves are uncertain – the timing of a loss event and the amount of a loss usually cannot be determined for certain. What's more, ultimately the loss event may not take place at all. As a result, most decisions on reserves are based on assumptions and estimates made by the entity.

Second, because of that specific nature of reserves, it is very difficult to create universal rules of their recognition and measurement.

Third, the sources of complexity of reserves go beyond their inherent features and stem from the general orientation of contemporary accounting. Clearly, the movement form the historical cost measurement and the concentration on past events to the measurement based on estimated values and predicted future events affects the area of reserves. There is a distinct shift of focus from the recognition of incurred losses to the recognition of anticipated losses in net assets. It becomes a great challenge for entities to estimate and recognize a reserve – they have to identify conditional and unconditional obligations, distinguish liabilities from business risk, observe internal and external environment searching for indications of impairment of assets, asses the probability of future events. Under this circumstances it's very important to be able to rely on clear guidelines which would help entities to achieve a faithful representation of loss in net assets.

The analysis of the existing standards, as well as current developments of IFRSs on reserves proves that this is a particularly challenging area for the accounting regulators.

Some of the planned solutions on provisions may be seen as very controversial. In particular, the lack of obligation to use the term provision in financial statements may create information deficiency and distort the comparability of financial statements. The removal of probability criterion may result in the recognition of many conditional obligations with small probability of outflow of economic benefits, thus influencing the relevance of information. All these issues affect the most important qualitative characteristics of useful financial information, that's why they rather shouldn't be considered before a complete revision of conceptual framework. Moreover, some of the proposed changes (for example the use of expected values measurements for all obligations) may be very costly to apply in practice.

Considering the above, it's not surprising that many preparers, auditors, national accounting standard setters, accountants representative bodies do not support the continuation of the project in its current form.

Also another project carried by IASB – impairment of financial assets measured at amortised cost raises many concerns. However, whereas in relation to the project on liabilities observers disagree with its most fundamental issues, the developments in impairment of financial assets are generally supported (as it was explained in the article, the global financial crisis revealed weaknesses of the existing model). However, there are many questions and doubts concerning the potential operating difficulties of the new impairment model.

Both projects are still not completed[5]. It seems that at least the following assumptions should underlie the works of accounting regulators:

- some issues need to be addressed at the level of conceptual framework first (which is absolutely essential for an effective standard setting process),
- it's not always necessary to replace something that works well in practice for the sake of alignment with other standards (especially without previous debate on conceptual framework),
- the introduction of a new, more complex and sophisticated model can be justified only if it brings benefits that will overweigh the cost of practical implementation of new solutions.

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