Contingent Liabilities, Commitments and provisions in Oil Industry

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Some companies disclose the commitments separately from contingent liabilities, and some combined them in one note to which is called "contingencies and commitments". When we can classify the obligation either as provision which is presented in the face of financial positions, as contingent liabilities or as commitments in the notes to the financial statements.

Contingent liabilities are possible or present obligations that arise from past events and not recognized due to lack of probability of outflow of resources or lack of sufficient reliability of measuring amount of obligations. And the nature of contingent of liability is accounted for possibility of undesirable event or outcomes. Contingent liability gives an indicator that risk of loss is quite high and raised from either constructive or legal method. In other word, contingent is amount which is possible to be paid due to past events and it can not be estimated reliably, such as lawsuit expenses which is material and attorney of company expects there is possibility for outflow of resources but could not be estimated reliably.

Commitment is an intention or a decision to sacrifice future economic benefits (e.g. decision to purchase or undertake venture), and it is lack of present obligation because there is no enforceable or irrevocable agreement or in the irrevocable agreement, there is probability of either party of agreement would suffer substantial loss from cancellation of agreements. Also, the nature of commitment is directed towards a desirable event or outcomes. Commitment should be disclosed when a conditional contract is accepted and signed or order is placed or accepted but work has not been performed or materials have not been received yet, or decision is made by management in favor of applicant of grant, decision is made by management for incurring in capital expenditure.

Contingent liabilities and commitments are disclosed as off-balance sheets items, but provision is recorded as liability that is reported either current or non-current liabilities based on the time of expected payments.

Provision is subcatagory of liability for which amount or timing of future cash flow are certain, this liability is recorded and presented in the FS if company has constructive (Per Company's policy) or legal (Per contract or laws) present obligation to third party as results of past events, the cash flowout is probable and reliably measured, it should reflect the present value of expenditures expected to settle future obligations. The provision gives an indication that the risk of loss is quite high and probable.

What Contingent Liabilities, commitments and provisions can reflect

Contingent liabilities and commitments can materially effect the financial projections for budget year either to finance their commitments or liabilities by debts, internally, or issuing new shares.

A lot of companies likes to pattern their annual reports by giving a strong indication to creditors or investors that the Company is very strong in Corporate Social Responsibility (CSR), however, it may not be. How we can know the real Company's believes, attitudes or philosophy by reading the annual reports, Some companies like to state in the management discussion or information on company in their annual reports that they support environment and safety, have strong accountability and substantial commitment to reduce the pollution or substantial environmental remediation efforts, however, their financial statements does not show any provision for or even disclosure about or such things during about 5 - 10 years ago and in the current reporting year.

However, contingent liability and commitments may not practically be considered by credit analyst, it can lead the company to be deteriorated suddenly if it was not properly managed or analyzed. The analyst may has intense that the company does not generate cash flow and it is generating profit by understating the recorded or disclosed liabilities by understating the probabilities of occurrence which decorates its financial statements and give a false indication that Company has not any significant probable or possible liability or it achieved all its commitments successfully. Therefore, nobody can blame analyst about why they don't properly analyze the company's financial performance or business properly, analysts depends on only the financial information disclosed or presented and release press or announcements There is no practical and helpful analytical symptoms for detecting any omissions of contingent liabilities, but it can be detected by documentary symptoms which is reviewed by auditors.

How the contingent liability, commitments and provision is presented or disclosed in the financial statements?

As per IFRS1 B19 and IAS 31 and IAS 37 Companies should disclose the following:

1) Its share of unrecognized and unconditional purchase obligations that include procurement of equipment, inventory or services which Company is legally and enforceable committed to purchasing them from or on behalf of joint venture and to be used within a normal course of business.

2) separately disclose from other commitments of its share of capital commitments in joint ventures.

How the Oil Companies disclose the capital/ exploration commitments or purchase obligations:

There are different ways to disclose the exploration or capital commitments in the financial statements:

1) Some companies disclose them in the "contingent liability", other disclose them in the "commitments" note which separates it from "contingent liability", other disclose them in note "contingencies and commitments"
2) Also, Some companies disclose the expected capital and purchase commitments for five years in advance or one year, and categorize them in period intervals based on the capital or purchase program.
3) The capital expenditures and commitments is disclosed by discounted value or undiscounted value by several companies.
4) Disclose the how much the commitments that are in contract.

Provision for decommissioning or Asset Retirement Obligations, the provision for dismantling, decommissioning, restoring, remediating an assets or field location, should be recorded at present value of estimated cost, and to be annual valued at fair value and adjust any variances between the fair value and the recorded amount. The ARO or the provision of decommissioning should be carried in the long-lived assets (PP&E), the ARO is accreted for the increase in the present value which effects the expenses, and ARO is depreciated over the specific or economic life of assets. The details of ARO should be properly disclosed within PP&E or long-lived assets disclosures.

Provision can be categorized under current or non-current liability based on the expected maturity date of settling the liability. The provision for employee benefits of annual leave or accumulated sick leaves is reported as current liability but the provision for employee benefits of long service leave is reported under non-current liabilities.

For the minimum requirements obligations that are stated in the PSAs, Many companies disclose them in the management's discussion and analysis, business review or information on company. Also, these obligations are disclosed in the notes to the financial statements but different Companies disclose them in different category, minimum exploration commitments are disclosed either under

1) “Contingent liabilities note” arise from legal obligations and disclosed, or

2) “Commitments note” which is separated from “contingent liabilities”, and within the “capital expenditure and commitments” or “Contractual commitments”, or

3) “Commitments note” which is separated from “contingent liabilities”, and within the “Contractual commitments”, or

4) “Commitment note” which is separated from “contingent liabilities”, and in different from "capital expenditure and commitments", disclosed caption which is called "Exploratory work commitments", "minimum exploration commitments".

Also, the minimum exploration commitments are disclosed under "interest in jointly controlled entities or operations" too as share of capital commitment in jointly controlled entities or operations. Also, the minimum exploration commitments that is stated in the PSAs require irrevocable bank guarantee raised to host government, and this guarantee is disclosed under “Contingent liabilities” as bank guarantees which shows the amount of those guarantees.

In our view of point, it is transparent, and relevant to disclose the minimum exploration obligations separately and clearly as “minimum exploration obligations”, either as commitments or contingent liability based on the criteria of contingent liabilities or commitments they are met. Also, it is useful to disclose it as a separate information in the “interest in jointly controlled entities/operations” and as Company’s share of “minimum exploration commitments/obligations in joint venture”, disclose how much they were achieved of the minimum exploration commitments/obligations, disclose the Company's share of the such commitments by segmentation or geographical locations. Also, Company should disclose the bank guarantees that are issued against the minimum exploration requirements in the “contingent liability”

We believe this various disclosure is either required by various countries' regulations, Company's policy, Stock Exchange organization's requirements, and cost and benefit of such disclosure. We may heard that a company try to provide reasonable disclosure, but we need to know what is the minimum disclosure requirements that may need for any investors and analysts. The Companies should know the Stakeholder's requirements to provide more useful financial information by making quality financial information requirements analysis and matrix.