

ACCOUNTING & FINANCE

StBin [German tax consultant] Sabine Rössler

Warranty provisions – seriousness with respect to use and adjusting events

The Federal Fiscal Court (*Bundesfinanzhof, BFH*) has clarified, once again, the requirements with regard to the creation of provisions for liabilities of uncertain timing or amount. In a recent ruling from 28.8.2018 (case reference: X B 48/18), the Court explained that a provision may not be created if a deficiency already exists on the balance sheet date but the use of such a provision by the obligated party could however not be seriously expected at that time because both parties to the agreement are not yet aware of the deficiency.

1. Provisions for liabilities of uncertain timing or amount

Liabilities can be uncertain in terms of the reason and/ or the amount. Provisions have to be created, in particular, for:

- » an existing obligation to another party that is certain or probable,
- » that arose for legal or economic reasons and
- » provided that it is seriously expected that the provision will actually be used.

In its rulings, the BFH has already clarified, in many ways, the requirements with regard to the creation of provisions for liabilities of uncertain timing or amount.

2. Warranty obligations

Irrespective of the legal grounds on which a claim for compensation is based, thus whether the basis is legal or contractual, the crucial factor for the creation of warranty provisions is whether or not their use is mostly likely. This would imply that the obligee is aware of the circumstances on which a claim could be based. This would mean that, on the balance sheet date, complaints had already been made, or there was an expectation that complaints about deficiencies that had not yet been made would probably be put forward.

3. Principle of prudence

Following the principle of prudence, the conditions actually existing on the balance sheet date have to be assessed on the basis of a diligent businessperson's subjective knowledge level while drawing up the accounts within the

deadline. Therefore, no new circumstances, occurring only after the balance sheet date, should be recognised in the financial statements. By contrast, adjusting events have to be taken into account; these are facts already objectively existing on the balance sheet date but that become known only subsequently (i.e. between the balance sheet date and the time when the accounts were being drawn up).

4. Adjusting events

From an adjusting-events perspective, complaints that have not yet been made as at the balance sheet date could justify the recognition of a provision. An objective starting point here would also be a deficiency for which no complaint has yet been received but for which recourse is expected. Within the scope of evaluating an individual case, an assessment has to be made as to whether or not an inherent shortcoming with regard to what was contractually specified and already existed but which, due to the client's operating procedures, had not yet become obvious ("had not yet occurred") and, therefore, no complaint could even have been made, appears to be sufficient when conducting an evaluation to be able to determine if this adjusting event is serious with respect to the assumption that the contractor will use the provision.

Conclusion

According to the BFH, the risk of the use of the provision by the contractor would then not predominate if both parties to the agreement were not yet aware of the deficiency as at the balance sheet date because on that date the deficiency would not yet have developed any adverse effect on the business and, therefore, would not have appeared to be at all discernible. In such a case no provisions for liabilities of uncertain timing or amount could be created.