TOPIC 15

INDAS-37

Provisions, Contingent Liabilities and Contingent Assets

INDEX

S.No.	Content	Page No.
1	What is Provision?	364
2	When to Recognise Provision?	365
3	How to measure Provision?	367
4	How to account for Provision?	367
5	Provision in Specific circumstances	368
6	What are Contingencies?	369
7	Important Examples	371
8	Questions	373

Quote:-

Learn how to imagine a life better than your current situation.

What is the objective of INDAS 37?

The Standard INDAS 37 Provisions, Contingent Liabilities and Contingent assets sets the criteria for recognition and measurement of

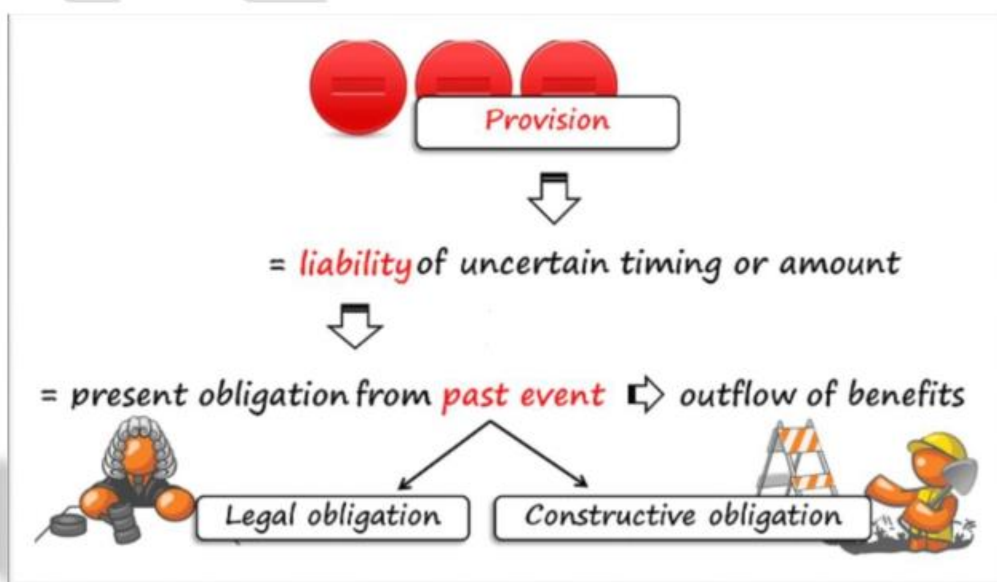
- Provisions;
- Contingent liabilities;
- Contingent assets; and

requires a number of disclosures about these items in order to understand them better.

What is a provision?

Provision is a liability of uncertain timing or amount.

The word "uncertain" is very important here, because if timing and amount are certain or almost certain, then you don't deal with the provision but with a payable or an accrual.



A ***liability*** is a ***present obligation*** arising from ***past event*** that is expected to be settled by an ***outflow of economic benefits*** from an entity.

In other words, ***if there is no past event, then there is no liability*** and no provision should be recognized.

Past event can create 2 types of obligation:

- ***Legal obligation*** that arises from legislation, a contract or other legal act; or
- ***Constructive obligation*** that arises from some business practice or customs and created an expectation in other parties to fulfill the obligation (in other words, people simply expect some company to fulfill the obligation even if it's not in the law or any contract).

Example of Constructive Obligation:

X Ltd. is engaged in the manufacture of fertilisers. Effluents discharged in the manufacturing process have polluted the river near the manufacturing plant. The residents of the nearby locality launched a massive agitation against the pollution. X Ltd. agreed to their demands to reduce the water pollution by installing the necessary Effluent Treatment Plant. However, during the year no steps are taken to install the plant. No legislation requiring the company to reduce its pollution is in existence. In this case, though there is no law but by promising to take steps to reduce pollution, X Ltd. Has created a valid expectation on the part of public that it will discharge its responsibilities.

So the obligation in this case is a constructive obligation.

It does not really matter what type of obligation you deal with – whichever it is, it leads to a provision. However, if you identify the obligation, it can help you to decide whether recognize a provision or not.

When to recognize a provision?

The standard INDAS 37 sets 3 criteria for recognizing a provision:

1. There must be a present obligation as a result of a past event;
2. The outflow of economic benefits to satisfy the obligation must be probable (i.e. more than 50% probable)
3. The amount of economic benefits required to satisfy the obligation must be reliably estimated.

COVID-19

If all 3 criteria are met, then you should recognize a provision.

If just one of them is not met, then you should either:

- Disclose a **contingent liability** (read more about it below), or
- **Do nothing** if the outflow of economic benefits is remote.

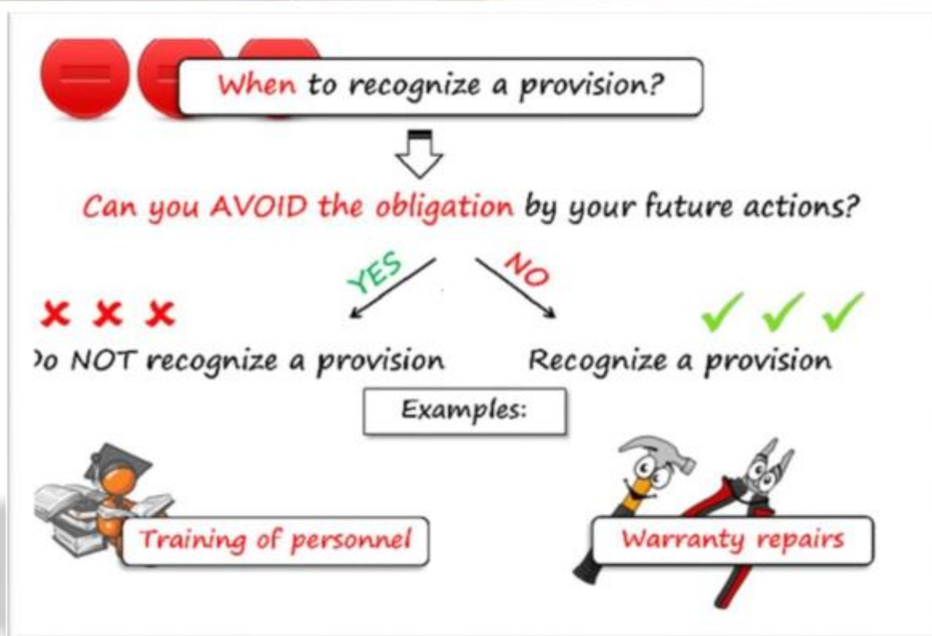
If you are unsure whether to recognize a provision in a particular situation or not, just ask yourself a simple question:

Can the obligation be avoided by some future actions?

If yes, then you should NOT book a provision. For example, if a government introduced new tax legislation, does the tax consulting company need to spend a cash for training of its employees and thus recognize a provision for that training?

No, it does not have to. Tax consulting company can avoid the training and decide to stop its activities.

If you cannot avoid the obligation by some future action, then you have to recognize a provision. For example, when you promised a free warranty service for defective products at the point of sale, then you have a present obligation. If your past statistics show that you needed to spend some cash for warranty repairs, then you need to make a provision.



How to measure a provision?

The amount of the provision should be measured at the best **estimate** of the expenditures required to satisfy the obligation at the end of the reporting period.

As you can see, here's some judgement and estimates involved. Management should really incorporate all available information in their estimates and they must not forget about:

- Risks and uncertainties (like inflation),
- Time value of money (discounting when the settlement is expected in the long-term future)
- Some probable future events, etc.

There are 2 basic methods of measuring a provision:

1. **Expected value method:** You would use this method when you have a range of possible outcomes or you measure the provision for large amount of items. In this case, you need to weight each outcome by its probability (for example, warranty repair costs for 10 000 products).

2. **The most likely outcome:** This method is suitable in the case of a single obligation or just 1 item (for example, provision for loss in the court case).

How to account for a provision?

There are several events associated with the accounting for provisions:

- **Recognition of a provision:** In most cases, you should recognize a provision in profit & loss a/c. Sometimes, a provision is recognized in the cost of another asset, for example, provision for removing the asset and restoring the site after its use.Don't forget to split the provision in the current and non-current part for the presentation purposes in your statement of financial position.
- **Unwinding the discount:** When a provision has a long-term nature (beyond 12 months), then there's some discounting involved as you need to present it in its present value. In each reporting period, weshould account for an interest on the opening balance of the provision and this is called "unwinding the discount".

  We should recognize the interest in profit or loss and it also increases the amount of a provision.
- **Reimbursement:** Sometimes, entities have right to reimbursement of related expenditures by the third party (e.g. from an insurance company).In this case, a right to

COVID-19

reimbursement is recognized as a separate asset (no netting off with the provision itself), but you can net off the expenses for provision with the income from reimbursement in the profit or loss.

How to account for a provision?

	DEBIT	CREDIT
Recognition of provision:	Expense / asset	Liability - provision
Unwinding the discount:	Finance cost	Liability - provision
Use of provision:	Liability - provision	Cash / bank etc.
Reimbursements:	Reimbursement asset	Expense

Provisions in specific circumstances

INDAS 37 specifies the treatment of provisions in a few specific situations:

Future operating losses

You should not make a provision for future operating loss.

Why?

Because there is no past event. The future operating losses can be avoided by some future actions, for example – by selling a business.

However, you should test your assets for impairment under INDAS 36 Impairment of Assets.

Onerous contracts

Onerous contract is a contract in which **unavoidable costs of fulfilling exceed the benefits** from the contract.

In other words, it is a loss contract that cannot be avoided.

You should make a provision in the amount lower of:

- Unavoidable costs of fulfilling the contract and
- Penalty for not meeting your obligations from the contract

Restructuring

Restructuring is a plan of management to **change the scope of business or a manner of conducting a business.**

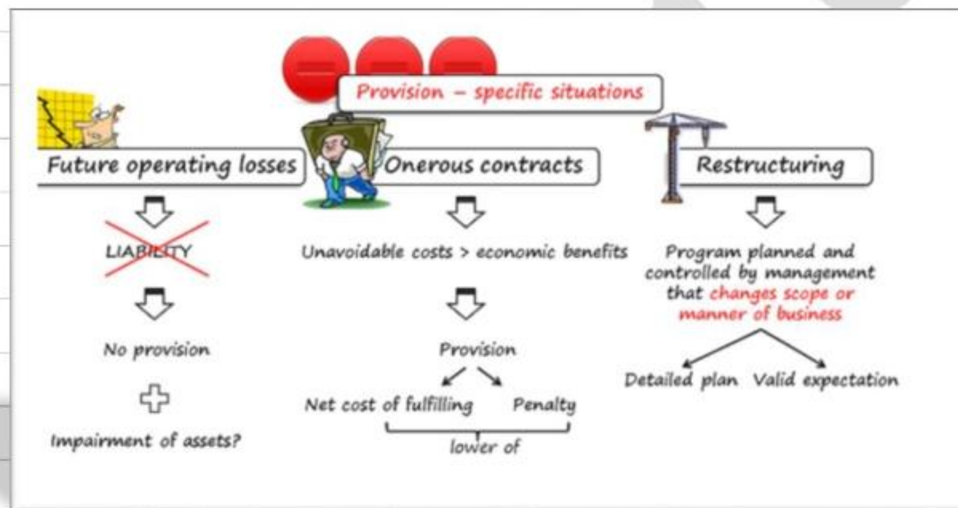
COVID

You should recognize a provision for restructuring only when the general criteria for recognizing provisions are met.

In the case of restructuring, an obligation to restructure arises only if:

- There is a **detailed formal plan** for restructuring with relevant information in it (about business, location, employees, time schedule and expenditures)
- A **valid expectation** related to restructuring has been raised in the affected parties.

INDAS 37 also clarifies which type of expenses can / cannot be included in the provision.



What are contingencies?

Except for provisions, we can deal both with contingent liabilities and contingent assets.

Contingent liabilities

A contingent liability is either:

- A possible obligation (not present) from past event that will be confirmed by some future event; or
- A present obligation from past event, but either:
- The ouflow of economic benefits to satisfy this obligation is not probable (less than 50%), or
- The amount of obligation cannot be reliably measured (this is very rare, in fact).

For example, you might face a lawsuit, but your lawyers estimate the probability of losing the case at 30% – in this case, it's not probable that you will have to incur any expenditures to settle the claim and you should not book a provision. It's typical contingent liability.

If you identify you have a contingent liability, you do ***NOT recognize it*** *– no journal entry. You should only* ***make appropriate disclosures*** *in the notes to the financial statements.*

Contingent assets

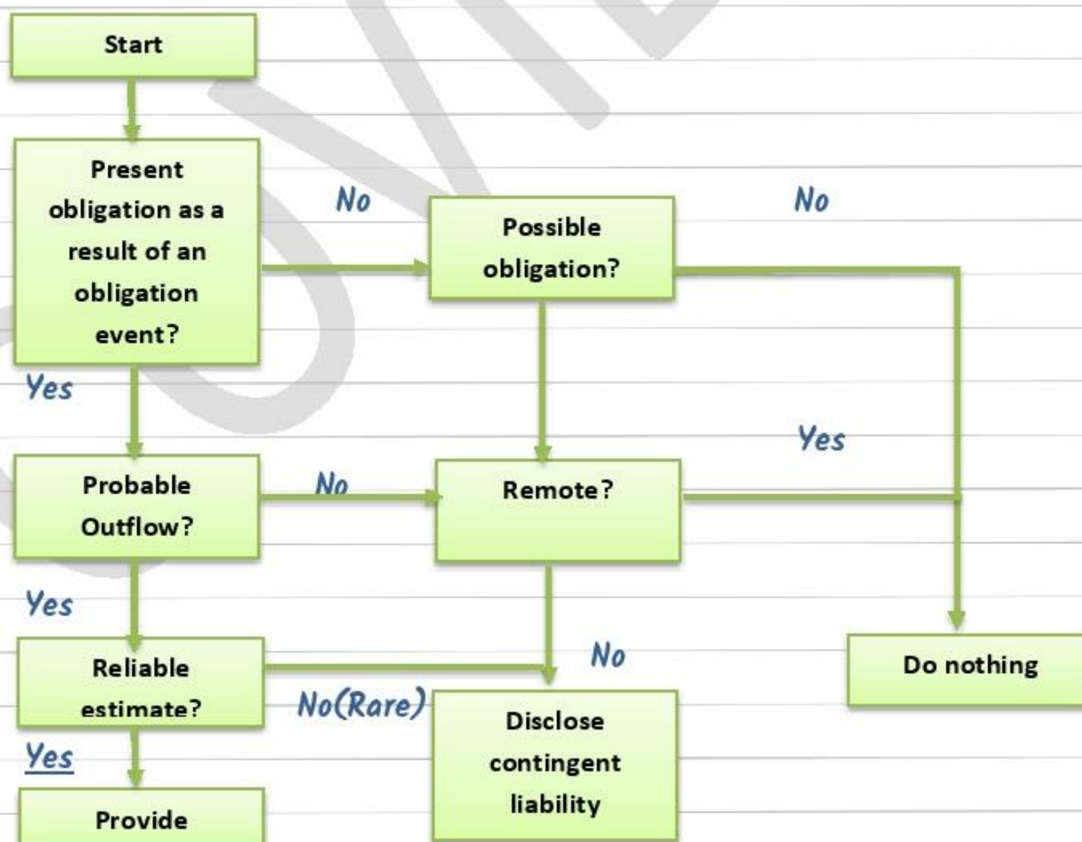
A contingent asset is a possible asset arising from past events that will be confirmed by some future events not fully under the entity's control.

Similarly as with contingent liabilities, you should not book anything in relation to contingent assets, but you make appropriate disclosures.

Tabular depiction

Likelihood of outcome	Contingent liability	Contingent asset
Virtually certain (greater than 95% probability)	Recognise the provision	Recognise the asset
Probable (50% - 95% of probability)	Recognise the provision	Disclose about the contingent asset
Possible but not probable (5% - 50% of probability)	Disclose the contingency	No disclosure permitted
Remote (less than 5% probability)	No disclosure permitted	No disclosure permitted

Decision Tree



EXAMPLES FROM ICAI MODULE:

Example: 1

Depreciation, impairment of assets and doubtful debts.

The provisions which are adjustments to the carrying amounts of assets are not addressed in Ind AS 37 since other Ind AS specifies their treatment. Ind AS 37 neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

Ind AS 37 applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations.

Example: 2

There should be a past event which lead to present obligation and give rise to a liability for which a provision is required to be made.

1. In respect of warranty provision, it would be the original sale.
2. In respect of contamination of land, it would be the original contamination.

- No provision is recognised for costs that need to be incurred by an entity to operate in the future.
- The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.
- It is only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) that should be recognised as provisions.
    1. Penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.
    2. Similarly, an entity should recognise a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused.

- In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future.

Example:3 Fitting smoke filters in a certain type of factory.

Since, the entity can avoid the future expenditure by its future actions, for example by changing its method of operation or discontinuation of business, it has no present obligation for that future expenditure and no provision is recognised.

Example:4 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under theterms of the contract for sale the manufacturer undertakes to make good, by repair orreplacement, manufacturing defects that become apparent within three years from the dateof sale. On past experience, it is probable (i.e., more likely than not) that there will be someclaims under the warranties. It is assumed that a reliable estimate can be made of anyoutflows expected.

Student Notes:-

COVID - 19

Questions from ICAI Module

Q159

X Shipping Ltd. is required by law to overhaul its shipping fleet once in every 3 years. The company's finance team was of the view that recognising the costs only when paid would prevent matching of revenue earned all the time with certain costs of large amounts which are incurred occasional. Thereby, it has formulated an accounting policy of providing in its books of account for the future cost of maintenance (overhauls, annual inspection etc.) by calculating a rate per hours sailed on sea and accumulating a provision over time. The provision is adjusted when the expenditure is actually incurred. Is the accounting policy of X Shipping Ltd. correct?

Solution

A provision is made for a present obligation arising out of a past event. Overhauling does not arise out of past event. Even a legal requirement to overhaul does not make the cost of overhaul a liability, because no obligation exists to overhaul the ships independently of the company's future actions - the company could avoid the future expenditure by its future actions for example by selling the ships. So there is no present obligation.

As per the standard, financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provisions recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period. Therefore, the accounting policy of X Shipping Ltd. is not correct. The company should adopt the component approach in Ind AS 16, Property, Plant and Equipment, for accounting for the refurbishment cost.

Q160

X Ltd. has entered into an agreement with its selling agent Y, in accordance with which XLtd. has to pay a base percentage of commission on export sales and an additional commission is to be paid if the export incentives are received. As per the accounting policyof X Ltd., it recognises export incentives when actually realised, on account of the uncertainty in realising such incentives. Export incentives have not been received for the year 20X1-20X2; however X Ltd. is hopeful of receiving the export incentives in the year 20X2-20X3. In the financial statements for 20X1-20X2, should X Ltd. provide for both base commission and additional commission?

Solution

So far as the base percentage of sales commission is concerned, it is a present obligation arising out of past events. The obligating event takes place when the sales are made and also since commission is based on percentage of sale, reliable estimation can also be made. Therefore, the base percentage of sales commission should be provided.

However, in respect of additional commission, it is to be paid when the export incentives are recognised and export incentives are recognised only when it is received. Therefore, the obligating event will arise only when export incentives are received. Hence, no provision for additional commission is to be made in financial year 20X1-20X2. The expectation of X Ltd. to receive the export incentives in next year would not make any difference as on31 March 20X2.In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.

Q161 [ICAI]

X Sugars Ltd. has entered into a sale contract of Rs 3,00,00,000 with Y Chocolates Ltd. for the supply of sugar during 20X1-20X2. As per the contract the delivery is to be made within 2 months from the date of contract. In case of failure to deliver within the schedule, X Sugars Ltd. has to pay a compensation of Rs 30,00,000 to Y Chocolates Ltd.

During the transit, the vehicle carrying the sugar met with accident and X Sugar Ltd. lost the entire consignment. It is, however covered by an insurance policy. According to the report of the surveyor, the amount is collectible, subject to the deductible clause [i.e., 15% of the claim] in the insurance policy. The cost of goods lost was Rs 2,50,00,000.

Before the financial year end, X Sugars Ltd. received informal information from the insurance company that their claim had been processed and the payment had been dispatched for 85% of the claim amount. Meanwhile Y Chocolates Ltd. has made demand of Rs 30,00,000 since the goods were not delivered on time. What provision or disclosure would X Ltd. need to make at year end?

Solution

As per the standard, where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out in Ind AS 37.

Since Insurance claim has been passed, X should recognised receivable asset at Rs 21250000

It would also need to make a provision of Rs 30,00,000 towards the clam of Y Chocolates Ltd.

COVID-19

Q162

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of Rs 1 million would result. If major defects were detected in all products sold, repair costs of Rs 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects. In accordance with the standard, an entity assesses the probability of an outflow for the warranty obligations as a whole.

Solution

The expected value of the cost of repairs is:
(75% of nil) + (20% of 1m) + (5% of 4m) = Rs 4,00,000

- Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes.
- Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

Q163

X Solar Power Ltd., a power company, has a present obligation to dismantle its plant after 35 years of useful life. X Solar Power Ltd. cannot cancel this obligation or transfer to third party. X Solar Power Ltd. has estimated the total cost of dismantling at Rs 50,00,000, the present value of which is Rs 30,00,000. Based on the facts and circumstances, X Solar Power Ltd. considers the risk factor of 5% i.e., the risk that the actual outflows would be more from the expected present value. How should X Solar Power Ltd. account for the obligation?

Solution

The obligation should be measured at the present value of outflows i.e., Rs 30,00,000. Further a risk adjustment of 5% i.e., Rs 1,50,000 (Rs 30,00,000 x 5%) would be made.
So, the liability will be recognised at = Rs 30,00,000 + Rs1,50,000 = Rs 31,50,000.

COVID-19

Q164

X Beauty Solutions Ltd. is selling cosmetic products under its brand name 'B', but it is getting its product manufactured from Y Ltd. It has an understanding with Y Ltd. that if the company becomes liable for any damage claims, due to any injury or harm to the customer of the cosmetic products, 30% will be reimbursed to it by Y Ltd. During the financial year 20X1-20X2, a claim of Rs 30,00,000 becomes payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?

Solution

Alternative I

X Beauty Solutions Ltd. will get reimbursement of Rs 9,00,000 (Rs 30,00,000 x 30%) from Y Ltd. So, X Beauty Solutions Ltd. should make a provision of Rs 21,00,000 (Rs 30,00,000 - Rs 9,00,000) in financial year 20X1-20X2 and disclose a contingent liability of Rs 9,00,000. The contingent liability is recognised keeping in view the fact that in case Y Ltd. does not pay, then X Beauty Solutions Ltd. will be liable for the whole claim.

Alternative II :-

Gross liability shall be booked at 30,00,000 and separate asset shall be booked at 9,00,000.

Q165 – Unwinding the discount

X Telecom Ltd. has income tax litigation pending before appellate authorities. Legal advisor's opinion is that X Telecom Ltd. will lose the case and estimated that liability of Rs 1,00,00,000 may arise in two years. The liability is recognised on a discounted basis. The discount rate at which the liability has been discounted is 10% and it is assumed that discount rate does not change over the period of 2 years. How should X Telecom Ltd. calculate the amount of borrowing cost?

Solution

The discount factor of 10% for 2 years is 0.827. X Telecom Ltd. will initially recognise provision for Rs 82,70,000 (rs 1,00,00,000 x 0.827). The discount factor of 10% at the end of year 1 is 0.909. At the end of year 1, provision amount would be Rs 90,90,000 (Rs 1,00,00,000 x 0.909). As per the standard, the difference between the two present values i.e., Rs 8,20,000 is recognised as a borrowing cost in year 1. At the end of the Year 2, the liability would be Rs 1,00,00,000.The difference between the two present values i.e., Rs 9,10,000 (Rs 1,00,00,000 - Rs 90,90,000) is recognised as borrowing cost in year 2.

Q166

X Chemicals Ltd. engaged in the chemical industry causes environmental damage by dumping waste in the river near its factory. It does not clean up because there is no environmental legislation requiring cleaning up and X Chemicals Ltd. is causing damage for last 40 years. As

COVID-19

at March 31, 20X2, the State Legislature has passed a path breaking legislation requiring all polluting factories to clean-up the river water already contaminated. The formal Gazette notification of the law is pending. How should X Chemicals Ltd. deal with this situation?

Solution

The obligating event is the contamination of water and because of the virtually certainty of legislation requiring cleaning up, an outflow of resources is certain. It is possible to arrive at best estimated cost for the cleanup activity. So, a provision should be recognised in the books of X Chemicals Ltd. for 20X1-20X2.

Q167

X Packaging Ltd. has two segments, packaging division and paper division. In March 20X1, the board of directors approved and announced a formal plan to sell the paper division in June 20X1. Operating losses of the paper division are estimated to be approximately Rs 50,00,000 during the period from April 1, 20X1 to the expected date of disposal. Management of X Packaging Ltd. wants to include the future operating loss of Rs 50,00,000 in a provision for restructuring in the financial statements for the period ended March 31, 20X1. Can X Packaging Ltd. include these operating losses in a provision for restructuring?

Solution

Standard states that provision should not be made for future operating losses. Since Ind AS 37 prohibits the recognition of future operating losses, so X Packaging Ltd. Should not include these future operating losses in a provision for restructuring even though these losses relate to the disposal group.

Q168

X Metals Ltd. had entered into a non-cancellable contract with Y Ltd. to purchase 10,000 units of raw material at Rs 50 per unit at a contract price of Rs 5,00,000. As per the terms of contract, X Metals Ltd. would have to pay Rs 60,000 to exit the said contract. X Metals Ltd. has discontinued manufacturing the product that would use the said raw material. For that X Metals Ltd. has identified a third party to whom it can sell the said raw material at Rs 45 per unit.

How should X Metals Ltd. account for this transaction in its books of account in respect of the above contract?

COVID-19

Solution

These circumstances do indicate an onerous contract. The only benefit to be derived from the purchase contract costing Rs 5,00,000 are the proceeds from the sale contact, which are Rs 4,50,000. Therefore, a provision should be made for the onerous element of Rs 50,000, being the lower of cost of fulfilling the contract and the penal cost of cancellation of Rs 60,000.

Q169

X Cements Ltd. has three manufacturing units situated in three different states of India. The board of directors of X Cements Ltd., in their meeting held on January 10, 20X1, decided to close down its operations in one particular state on account of environmental reasons. A detailed formal plan for shutting down the above unit was also formalised and agreed by the board of directors in that meeting, which specifies the approximate number of employees who will be compensated and expenditure expected to be incurred. Date of implementation of plan has also been mentioned. Meetings were also held with customers, suppliers, and workers to communicate the features of the formal plan to close down the operations in the said state, and representatives of all interested parties were present in those meetings. Do the actions of the board of directors create a constructive obligation that needs a provision for restructuring?

Solution

As per Ind AS 37, the conditions prescribed are:

(a) there should be detailed formal plan of restructuring;

(b) Which should have raised valid expectations in the minds of those affected that the entity would carry out the restructuring by announcing the main features of its plans to restructure.

(c) The board of directors did discuss and formalise a formal plan of winding up the operation in the above said state. This plan was communicated to the parties affected and created a valid expectation in their minds that X Cements Ltd. would go ahead with its plans to close down operations in that state. Thus, there is a constructive obligation that needs to be provided at year-end.

COVID-19

Student Notes:-

COVID - 19

Student Notes:-

COVID-19

Student Notes:-

COVID-19

Student Notes:-

COVID - 19

COVID-19

COVID - 19