

## CHAPTER 13

# AS 29: PROVISIONS, CONTINGENT LIABILITIES & CONTINGENT ASSETS

### C1: PROVISION

#### **Problem.1.1**

Alloy Fabrication Limited is engaged in manufacturing of iron and steel rods. The company is in the process of finalization of the accounts for the year ended 31<sup>st</sup> March, 2022 and needs your advice on the following issues in line with the provisions of AS-29:

- (i) On 1<sup>st</sup> April, 2019, the company installed a huge furnace in their plant. The furnace has a lining that needs to be replaced every five years for technical reasons. At the Balance Sheet date 31<sup>st</sup> March, 2022, the company does not provide any provision for replacement of lining of the furnace.
- (ii) A case has been filed against the company in the consumer court and a notice for levy of a penalty of ₹ 50 Lakhs has been received. The company has appointed a lawyer to defend the case for a fee of ₹ 5 Lakhs. 60% of the fees have been paid in advance and rest 40% will be paid after finalization of the case. There are 70% chances that the penalty may not be levied.

[May 2022, 5 Marks]

#### **Solution**

- (i) A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29. The cost of replacement of lining of furnace is not recognized as a provision because it is a future obligation.

Even a legal requirement does not require the company to make a provision for the cost of replacement because there is no present obligation. Even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

- (ii) As per AS 29, an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. Liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

In the given case, there are 70% chances that the penalty may not be levied. Accordingly, Alloy Fabrication Ltd. should not make the provision for penalty. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

However, a provision should be made for remaining 40% fees of the lawyer amounting ₹ 2,00,000 in the financial statements of financial year 2021-2022.

#### **Problem.1.2**

Y Ltd. has book debts and has a doubt over recoverability of some of the book debts. The amount that cannot be recovered is not quantifiable. Thus, Y Ltd. is of the opinion that provision for doubtful debts should not be created. Y Ltd. creates provision for certain other expenses on estimated basis. Whether contention of Y Ltd. is correct?

[SM.7]

**Solution**

As per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date" if it is likely that a contingency will result in a loss to an entity then it should create provision for that contingency on the estimated basis.

Based on the above, the contention that provision for doubtful debt is not be created merely because the amount is not quantifiable is not correct. Hence Y Ltd. should make provision in the books on the basis of estimation.

**C2: MEASUREMENT OF PROVISIONS**

**Problem.2.1**

At the end of the financial year ending on 31<sup>st</sup> December, 20X1, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors.

The possible outcome as estimated by the Board is as follows:

	Probability	Loss (₹)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Lose (Low damages)	40%	1,20,000
Lose (High damages)	10%	2,00,000
Remaining five cases		
Win	50%	-
Lose (Low damages)	30%	1,00,000
Lose (High damages)	20%	2,10,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

**[S.M.1]**

**Solution**

According to AS 29 (Revised) 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

- (i) There is a present obligation arising out of past events but not recognized as provision.
- (ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- (iii) The possibility of an outflow of resources embodying economic benefits is not remote.
- (iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 50% and for remaining five cases is 50%. As per AS 29 (Revised), we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 40% of ₹ 1,20,000 + 10% of ₹ 2,00,000  
= ₹ 48,000 + ₹ 20,000 = ₹ 68,000

Expected loss in remaining five cases = 30% of ₹ 1,00,000 + 20% of ₹ 2,10,000  
= ₹ 30,000 + ₹ 42,000 = ₹ 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 10,40,000 (₹ 68,000 × 10 + ₹ 72,000 × 5) as contingent liability.

### **Problem.2.2**

EXOX Ltd. is in the process of finalising its accounts for the year ended 31<sup>st</sup> March, 20X2. The company seeks your advice on the following:

- (i) The Company's sales tax assessment for assessment year 20X1-X2 has been completed on 14<sup>th</sup> February, 20X4 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.
- (ii) The Company has entered into a wage agreement in May, 20X2 whereby the labour union has accepted a revision in wage from June, 20X1. The agreement provided that the hike till May, 20X2 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 20X2. **[S.M.2]**

### **Solution**

- (i) Since the company is not appealing against the addition of ₹ 0.66 crore the same should be provided for in its accounts for the year ended on 31<sup>st</sup> March, 20X4. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed as a contingent liability of ₹ 2.10 crore.
- (ii) The arrears for the period from June, 20X1 to March, 20X2 are required to be provided for in the accounts of the company for the year ended on 31<sup>st</sup> March, 20X2.

### **Problem.2.3**

A Ltd. provides after sales warranty for two years to its customers. Based on past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period.

Less than 1 year: 2% provision  
 More than 1 year: 3% provision  
 The company has raised invoices as under:

Invoice Date	Amount (₹)
11 <sup>th</sup> Feb, 2017	60,000
25 <sup>th</sup> Dec, 2017	40,000
04 <sup>th</sup> Oct, 2018	1,35,000

Calculate the provision to be made for warranty under AS-29 as at 31<sup>st</sup> March, 2018 and 31<sup>st</sup> March, 2019. Also compute amount to be debited to P & L account for the year ended 31<sup>st</sup> March, 2019.

**[Nov. 2019, 5 Marks]**

**Solution**  
 Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

As at 31<sup>st</sup> Mar. 2018 = ₹ 60,000 × .02 + ₹ 40,000 × .03 = ₹ 1,200 + ₹ 1,200 = ₹ 2,400  
 As at 31<sup>st</sup> Mar. 2019 = ₹ 40,000 × .02 + ₹ 1,35,000 × .03 = ₹ 800 + ₹ 4,050 = ₹ 4,850

**Amount debited to Profit and Loss Account for year ended 31<sup>st</sup> March 2019**

	₹
Balance of provisions required as on 31.03.2019	4,850
<b>Less:</b> Opening Balance as on 1.4.2018	<u>(2,400)</u>
Amount debited to profit and loss account	<b><u>2,450</u></b>

**Note:** No provision will be made on 31<sup>st</sup> March, 2019 in respect of sales amounting ₹ 60,000 made on 11<sup>th</sup> February, 2017 as the warranty period of 2 years has already expired.

**C10: CONTINGENT ASSETS**

**Problem.10.1**  
 Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 20X1-20X2 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 20X2-20X3 financial year.  
 In case of failure of Sun Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 20X1-20X2 financial year. As on balance sheet date (31.3.20X2), the goods were not manufactured, and it was unlikely that Sun Ltd. will be able to meet the contractual obligation.

(i) Should Sun Ltd. provide for contingency as per AS 29?  
 (ii) Should provision be measured as the excess of compensation to be paid over the profit? **[7.1]**

**Solution**  
 (i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should

be recognized. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting ₹ 1.5 crores as per AS 29.

- (ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 20X2 and no profit had accrued for the financial year 20X1-20X2. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.50 crores.

### **Problem.10.2**

An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31<sup>st</sup> March 20X1, it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary?

### **Solution**

As per para 29 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a past event will lead to present obligation when the enterprise has no realistic alternative to settle the obligation created by the past event.

However, when environmental damage is caused, there may be no obligation to remedy the consequences. The causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

In the given case it is virtually certain that law will be enacted requiring clean-up of a land already contaminated. Therefore, an oil company has to provide for such clean-up cost in the year in which the law is virtually certain to be enacted.

### **Problem.10.3**

With reference to AS 29, how would you deal with the following in the Annual Accounts of the company at the Balance Sheet date:

- (i) The company operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Eighty five percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and fifteen percent arise through the extraction of oil. At the balance sheet date, rig has been constructed but no oil has been extracted.
- (ii) The Government introduces a number of changes to the taxation laws. As a result of these changes, the company will need to train a large proportion of its accounting and legal workforce in order to ensure continued compliances with tax law regulations. At the balance sheet date, no retraining of staff has taken place.

[Nov. 2020, 5 Marks]

**Solution**

(i) The construction of the oil rig creates an obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event.

At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement is probable. Thus, a provision is recognized for the best estimate of 85% of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig.

However, there is no obligation to rectify the damage that will be caused by extraction of oil, as no oil has been extracted at the balance sheet date. So, no provision is required for the cost of extraction of oil at balance sheet date. 15% of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

(ii) **As per AS 29**, a provision for restructuring costs is recognized only when the recognition criteria for provisions are met. A restructuring provision does not include costs as of retraining or relocating continuing staff. The expenditures of training the staff related to the future conduct of the business and are not liabilities for restructuring at the balance sheet date.

Such expenditures are recognized on the same basis as if they arose independently of a restructuring. At the balance sheet date, no such expenditure has been incurred hence no provision is required.

**C11**

**Problem.11.1**

At the end of the financial year ending on 31<sup>st</sup> March, 2022, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors.

The possible outcome as estimated by the Board is as follows:

Particulars	Probability	Loss (₹)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Lose (Low damages)	40%	12,00,000
Lose (High damages)	10%	20,00,000
Remaining five cases		
Win	50%	-
Lose (Low damages)	30%	10,00,000
Lose (High damages)	20%	21,00,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof as per AS-29.

**[Nov. 2022, 5 Marks]**

**Solution**

According to AS 29 (Revised) 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

1. There is a present obligation arising out of past events but not recognized as provision.
2. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
3. The possibility of an outflow of resources embodying economic benefits is not remote.
4. The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 50% and for remaining five cases is 50%.

As per AS 29 (Revised), we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

$$\begin{aligned} \text{Expected loss in next ten cases} &= 40\% \text{ of } ₹ 12,00,000 + 10\% \text{ of } ₹ 20,00,000 \\ &= ₹ 4,80,000 + ₹ 2,00,000 \\ &= ₹ 6,80,000 \end{aligned}$$

$$\begin{aligned} \text{Expected loss in remaining five cases} &= 30\% \text{ of } ₹ 10,00,000 + 20\% \text{ of } ₹ 21,00,000 \\ &= ₹ 3,00,000 + ₹ 4,20,000 \\ &= ₹ 7,20,000 \end{aligned}$$

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of 1,04,00,000 (₹ 6,80,000 x 10 + ₹ 7,20,000 x 5) as contingent liability.

**C12: MULTIPLE CHOICE QUESTIONS**

1. What is a provision according to AS 29?
  - (a) A liability of uncertain timing or amount
  - (b) An obligation that is likely to result in an outflow of resources
  - (c) A possible obligation depending on future events
  - (d) An obligation always recognized in financial statements
2. AS 29 defines a contingent liability as:
  - (a) A present obligation arising from past events
  - (b) A possible obligation or a present obligation that may, but probably will not, require an outflow of resources
  - (c) A liability that is not probable to require an outflow of resources
  - (d) An obligation that is certain to require an outflow of resources

3. According to AS 29, contingent assets are:
  - (a) Recognized as soon as possible
  - (b) Not recognized in financial statements but disclosed when an inflow of economic benefits is probable
  - (c) Always disclosed in financial statements.
  - (d) Recognized in financial statements when certain
4. Under AS 29, a restructuring provision is made when:
  - (a) There is a future operating loss
  - (b) There is a possible outflow of resources
  - (c) An obligating event occurs and the outflow of resources is probable
  - (d) The entity intends to restructure in the future
5. When should a provision be revised according to AS 29?
  - (a) Annually
  - (b) When there is a significant change in the estimated obligation
  - (c) Every quarter
  - (d) Only when the provision is settled
6. AS 29 states that a provision should be recognized when:
  - (a) There is a possible future obligation
  - (b) An obligating event has occurred, and it is probable that an outflow of resources will be required to settle the obligation
  - (c) The management intends to incur the expenditure
  - (d) There is a remote possibility of an outflow of resources
7. What does AS 29 say about recognizing a contingent asset?
  - (a) It should be recognized when it is possible that an inflow of benefits will occur
  - (b) It is recognized when the realization of income is virtually certain
  - (c) It should be disclosed in the financial statements when there is a reasonable possibility of inflow
  - (d) It should not be disclosed or recognized until inflow is certain
8. The use of estimates in measuring provisions according to AS 29 implies that:
  - (a) Provisions are always exact figures
  - (b) Provisions require a high degree of estimation
  - (c) Provisions should be based on past events only
  - (d) Estimation for provisions is not permitted under AS 29
9. If a company estimates a 60% chance of a ₹ 100,000 lawsuit settlement, what is the provision amount to be recognized as per AS 29?
  - (a) ₹ 60,000
  - (b) ₹ 100,000
  - (c) 0
  - (d) Cannot be determined from the given information

10. A company faces a potential obligation of ₹ 500,000 due to a lawsuit, with a 50% chance of losing. According to AS 29, how should it be treated?
- (a) Recognize a provision ₹ 500,000
  - (b) Disclose as a contingent liability
  - (c) Recognize a provision of ₹ 250,000
  - (d) No recognition or disclosure needed
11. Analyze how changes in laws can impact the recognition of provisions under AS 29.
- (a) Changes in laws do not affect provisions
  - (b) Only changes in tax laws affect provisions
  - (c) Provisions may need to be adjusted if laws create new obligations
  - (d) Laws have no impact unless related to financial reporting
12. If a company revises its estimate for an existing provision from ₹ 200,000 to ₹ 150,000, what is the impact on its financial statements?
- (a) Decrease in liabilities and expenses by ₹ 50,000
  - (b) Increase in liabilities by ₹ 50,000
  - (c) No impact on financial statements
  - (d) Increase in expenses by ₹ 50,000
13. Evaluate the impact on a company's financial statements if it fails to recognize necessary provisions as per AS 29.
- (a) Overstated liabilities and understated expenses
  - (b) Understated liabilities and overstated profits
  - (c) No impact as provisions are contingent in nature
  - (d) Overstated assets and understated liabilities
14. Create a scenario where a company estimates a potential liability for an environmental claim. If the company assesses there's a 30% chance of a ₹ 500,000 liability and a 70% chance of a ₹200,000 liability, what is the expected provision amount as per AS 29?
- (a) ₹ 2,90,000
  - (b) ₹ 3,50,000
  - (c) ₹ 2,15,000
  - (d) ₹ 5,00,000
15. AS 29 requires which approach for measuring provision?
- (a) Best estimate of the expenditure required settle the present obligation
  - (b) Maximum amount of the expenditure required
  - (c) Average of all possible outcomes
  - (d) Minimum amount in a range of possible outcomes
16. In AS 29, a provision should be used only for:
- (a) Expenditures for which the provision was originally recognized
  - (b) Any future business expenses
  - (c) Settling financial liabilities
  - (d) Investment purposes

17. How does AS 29 recommend dealing with large populations of similar obligations?
- (a) Treat each obligation individually
  - (b) Aggregate the entire population for estimation
  - (c) Ignore these obligations until they become due
  - (d) Use statistical methods to estimate the obligation
18. When should a provision be discounted under AS 29?
- (a) When the effect of the time value of money is material
  - (b) Always, regardless of the amount or timing
  - (c) Only for long-term provisions
  - (d) Discounting is not allowed under AS 29
19. AS 29's guidance on restructuring provisions requires that:
- (a) The restructuring plan is announced publicly
  - (b) The management has started implementing the plan
  - (c) An obligating event has occurred
  - (d) All employees are informed about the plan
20. What factors should be considered in estimating the amount of a provision according to AS 29?
- (a) Risks and uncertainties of the underlying events
  - (b) Only the most likely outcome
  - (c) Historical data only
  - (d) Potential for future profitability
21. Calculate the provision required for a warranty obligation, given 10% product failure rate on 1,000 units sold, each unit costing ₹ 500 to repair or replace.
- (a) ₹ 50,000      (b) ₹ 5,000      (c) ₹ 500,000      (d) ₹ 100,000
22. If an entity has a 40% probability of incurring a legal settlement of ₹ 200,000, what provision should be recognized as per AS 29?
- (a) ₹ 80,000      (b) ₹ 200,000  
(c) 0      (d) Cannot be determined
23. Analyze how the present value of a provision is affected by an increase in the discount rate used.
- (a) Increases the present value of the provision
  - (b) Decreases the present value of the provision
  - (c) Has no effect on the present value
  - (d) The effect can be variable
24. Assess the impact on an entity's financial position if a contingent liability becomes a provision.
- (a) Increases liabilities and reduces equity
  - (b) Decreases liabilities and increases equity
  - (c) No impact on liabilities but increases expenses
  - (d) Reduces assets and increases expenses

25. Evaluate the impact of not recognizing a necessary provision on an entity's financial statements and audits.
- (a) Understates liabilities and overstates profits
  - (b) Overstates liabilities and understates profits
  - (c) No impact on the financial statements
  - (d) Results in audit qualifications
26. A company faces potential legal claims related to a product defect. The legal team estimates a 40% probability of a ₹ 1,000,000 settlement and a 60% probability of no settlement. According to AS 29, what is the appropriate provision to be recognized?
- (a) ₹ 400,000
  - (b) ₹ 600,000
  - (c) ₹ 1,000,000
  - (d) No provision required
27. In AS 29, which of the following is not a valid basis for making a provision?
- (a) Future business operating losses
  - (b) Onerous contracts
  - (c) Environmental Cleanup
  - (d) Legal obligations
28. AS 29's guidance on provisions for onerous contracts requires:
- (a) Provision for the least net cost of exiting the contract
  - (b) Recognition of the full amount of the contract
  - (c) Recognition of any potential gain from the contract
  - (d) No provision unless there is a legal obligation
29. Under AS 29, how are contingent assets treated in financial statements when their realization becomes virtually certain?
- (a) They are disclosed in the notes to the financial statements
  - (b) They are recognized immediately in the balance sheet
  - (c) They remain as contingent until realized in cash
  - (d) They are recognized in the profit and loss account
30. Calculate the provision to be recognized for a warranty obligation: 1,000 units sold, each with a 5% chance of needing a ₹ 10,000 repair
- (a) ₹ 500,000
  - (b) ₹ 50,000
  - (c) ₹ 100,000
  - (d) ₹ 1,000,000
31. Analyze the impact on an entity's financial position if a recognized provision is later deemed unnecessary and reversed.
- (a) Increase in liabilities and decrease in profit
  - (b) Decrease in liabilities and increase in profit
  - (c) No change in liabilities, increase in expenses
  - (d) Decrease in assets and equity



**ANSWERS**

1 (a)	2 (b)	3 (b)	4 (c)	5 (b)	6 (b)	7 (b)	8 (b)	9 (a)	10 (b)
11(c)	12(a)	13 (b)	14 (a)	15 (a)	16 (a)	17 (b)	18 (a)	19 (c)	20 (a)
21 (a)	22 (a)	23 (b)	24 (a)	25 (a)	26 (a)	27 (a)	28(a)	29(b)	30(b)
31 (b)	32 (a)	33 (a)	34 (a)	35 (b)	36 (c)	37 (c)			