Ind AS 37 – Provisions, Contingent Liab, Contingent Asset

1. **Provision** – Liability of Uncertain timing or amount
   (Estimation)

2. **Liability** – Present obligation arising from past events, settlement of which result in an outflow of resources embodying economic benefits.

3. **An Obligant Event** – Event that creates legal or constructive obligation having no realistic alternative to settling that obligation.
   (Legal: Contract, legislation, law)
   (Constructive: Past practices which created valid expectations.)

4. **Contingent Liability**
   a. Possible obligation that arises from past events whose existence will be confirmed only by the occurrence or non occurrence of uncertain future events not within the control of Entity. OR
      (Yet to be confirmed whether entity has present obligation.)
   b. Present obligation arises from past events but not recognised because
      (less than 50% chance)
      – Not Probable that outflow of resources will be required. OR
      – Amount of obligation cannot be measured reliably.

   Contingent Liability is not recognised. Only disclosure is required.

5. **Provision should be recognised when** – (All conditions to be met)
   a) Entity has PRESENT OBLIGATION as a result of past events
      (Legal or Constructive.)
   AND
   b) Probable that outflow of resources required to settle obligation.
      (more than 50%)
   AND
   c) Amount of obligation can be measured reliably.

Examples of Past Events

Provisions / Contingent Liabilities	Past Events
1. In respect of contamination of land	Original contamination.
2. Provision for Decommissioning cost	Installation of PPE
3. Penalty for breach of contract	Breach of contract.
4. Provision for warranty obligation	Date of original sale.

Note Where it is not clear whether there is a present obligation, Entity should evaluate past events and take into account all possible evidence, including opinion of experts. On the basis of such evidence,

Where it is Probable that Present Obligation exist – Provisions made.
↳ more likely than not i.e. > 50%

Where it is not Probable that Present obligation exists – Contingent Liability

No Provision is recognised for cost that need to be incurred to operate in the future. The entity can avoid future expenditure by its future actions. (for example by changing its method of operation.)

Say, Fitting smoke filters in a certain type of factory.

Example 3 – 9

Not Virtually certain – Contingent Asset
Virtually certain → Not a Contingent Asset.

Contingent Assets

Contingent Assets are not recognised in F/s because they may never be realised. However when realisation of income is virtually certain, then related asset is not contingent asset and its recognition is appropriate.

Inflow of Economic Benefits not Probable (≤ 50%)	– No Asset is recognised.
Inflow of Economic Benefits Probable (> 50%)	– No Asset is recognised.
Inflow of Economic Benefits Virtually Certain (> 95%)	– Asset is recognised.

Measurement of Provision

While measuring provision, following points needs to be taken into account

1. Best Estimate

Estimates are determined by the judgement of the management, supplemented by experience of similar transaction and in some cases, reports of independent experts. (E.g. In legal cases, take expert legal advice) Example 11

Methods of Estimation

A. Expected value method.

Where provisions being measured involves a large population of items.
For E.g. Customer Refunds, Warranties etc.

Estimated by weighing all possible outcomes by their associated probabilities i.e. Expected value method.

B. Most likely Amount

Where a single obligation is being measured, the individual most likely amount may be the best estimate of liability.

2. Risk and Uncertainities

The risk and uncertainities should be taken into account in reaching best estimate of a provision. A risk adjustment should be made for the amount that entity would pay in excess of expected P.V. of outflows due to uncertainity attached with actual outcome.

Risk adjustment can be accounted in number of ways —

1. Adjusting the Discount Rate.
2. Adjusting the estimates of future outflows.
3. Adjusting it to expected P.V. of future outflows.

3. Present Value.

Where the effect of time value of money is material, the amount of Provision should be Present value of expenditures expected to be required to settle the obligation.
Provision should therefore be discounted, where the effect is material.

The discount rate should be a Pre-tax rate that reflects current market assessment of time value of money and the risks specific to the liability.

4. Future Events.

Future Events that may affect the amount required to settle the obligation should be reflected in the amount of provision where there is sufficient objective evidence that they will occur.

Eg.:- Entity may believe that cost of cleaning up a site at the end of its life will be reduced by future changes in technology.

5. Expected Disposal of Assets. {RESTRUCTURING COST}

Gain on Expected disposal of asset should not be taken into account in measuring a Provision.

Changes in Provision

Provision should be reviewed at the end of each reporting period and adjusted to reflect current best estimate.
If it is no longer probable that outflow of resources will be reqd. to settle obligation, the provision should be reversed.
Once the amount of obligation is crystallised and there is no uncertainity associated with obligation, the liability is no longer a provision.

Example 27

Customer X has made a claim of ₹ 2 million for liquidated damages, the entity is disputing the amount of claim. Due to the uncertainty involved in the amount payable, the entity recognises this as a provision. After negotiation with the customer, the amount is agreed at ₹ 1.5 million. As there is no uncertainty involved relating to the amount payable, it no longer meets the definition of provision and should be reclassified to an appropriate category within liabilities.

Shut Down → onerous contract
2 yrs lease Non Cancellable.

Future operating losses

Ind AS 37 do not permit recognition of provision for future operating losses since they do not stem from a past event.
But, this is an indication that certain asset of the operation may be impaired. Therefore entity should test these assets for impairment as per Ind AS 36.

Onerous Contracts

Contract in which unavoidable cost of meeting the obligations under the contract	EXCEEDED	The economic benefits expected to be received from it

If an entity has a contract that is onerous, present obligation should be recognised and measured as a provision.

The unavoidable cost reflect the least net cost of exiting from the contract.

Eg. Cost of the fulfilling the contract – ₹ 50000

Compensation / Penalties from failure to fulfill – ₹ 35000.

∴ Provision to be made (lower) = ₹ 35000

Reimbursements

Where some or all of the expenditures required to settle a provision is expected to be reimbursed by another party, the reimbursement should be separately recognised as an asset, when and only when, it is virtually certain that reimbursement will be received. (95% prob)

If entity will remain liable to settle the full amount if the third party failed to pay for any reason	If entity will not be liable for the costs in question if the third party fails to pay.
↓	↓
a provision should be recognised for the full amount of the liability, and a separate asset for the expected reimbursement should be recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.	In such a case the entity has no liability for those costs and they should not be included in the provision.

Eg: Provision to be made = ₹ 500000

Reimbursements = ₹ 350000

Journal

Reimbursement asset (⇒ more than 95% prob.)	350000	
Expenses (P/L)	150000	
To Provision (liability) (⇓ more than 50% prob.)		500000

Eg: Total Provision = 500000

Entity's obligation to pay = 60%

Journal

Expenses (P/L)	300000	
To Provision (liability)		300000

Note: Reimbursement amount recognised should not exceed amount of provision.

RESTRUCTURING

A restructuring is a programme that is planned and controlled by management, and materially changes either:

a) the scope of a business undertaken by an entity; or
b) the manner in which that business is conducted.

The following are examples of events that may fall under the definition of restructuring:

a) sale or termination of a line of business;
b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
c) changes in management structure, for example, eliminating a layer of management; and
d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

A provision for restructuring costs should be recognised only when the general recognition criteria for provisions set out the standard are met.

A constructive obligation to restructure arises only when an entity:

<table>
<tr><td>A. Has a detailed formal plan for the restructuring identifying at least:</td><td>i. the business or part of a business concerned;
ii. the principal locations affected;
iii. the location, function, and approximate number of employees who will be compensated for terminating their services;
iv. the expenditures that will be undertaken; and
v. when the plan will be implemented</td></tr>
<tr><td colspan="2">B. Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.</td></tr>
</table>

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

a) Necessarily entailed by the restructuring; AND
b) Not associated with the ongoing activities of the entity.

A restructuring provision does not include such costs as:

a) Retraining or Relocating Continuing Staff;
b) Marketing; or
c) Investment in new systems and distribution networks.

Expected Value method

Eg: Suppose Entity sold 10000 iphones for ₹ 50000 each. during the year.

Warranty - 2 years.

Bank	500000000	
To Revenue		500000000
(10000 × 50000)		

Prov. for warranty Exp.

75% Prob. → No Defects. → No cost

20% Prob. → minor defects → ₹ 2000000

5% Prob. → major defects → ₹ 5000000

Expected value method

$75\% \times 0 + 20\% \times 2000000 + 5\% \times 5000000$

$= 0 + 400000 + 250000$

$= 650000$

Warranty exp (P/L)	650000	
To Accrued warranty		650000

Most likely method

Suppose, Entity has contaminated land since many years. Under Newly Enacted legislation, Company should restore land to its original condition.

Present obligation, Prob. of O/F of resources, Amount of obligation can be measured reliably

Provision

Estimation

Technique 1 → 500000

Technique 2 → 650000 → most likely success.

Technique 3 → 900000

Prov. to be made for ₹ 650000

Another Eg.

Case filed by a Customer

60% Prob. → ₹ 100000 → most likely.

40% Prob → ₹ 0

Provision to be made → ₹ 100000

Present Value Concept

0th — 2nd yr End

Prov 1239669 ← 1500000

Pre tax Discount rate: 10%.

A/c (1239669) (Comp yr)

F/c (Int) → (123966)

A/c (Int) (136363)

A/cs

	Provision (Liab)	1239669
(+)	1st yr Borr. cost	123966
(+)	2nd yr Fi. cost	136363
		1500000

Risk & Uncertainities

1st case

0th

2nd yr

Exp. Prov → 1500000
(+ 10% Risk Adj) 150000
1650000

1363636 ← 10% Pre tax

$\frac{1650000}{(1.10)^2}$

2nd case

0th

2nd yr

Exp. Prov. → 1500000

1310001 ← 10% Pre tax
− 3 Adj
7% Pre tax

3rd case

0th

2nd yr

1500000

1239669 ← $(1.10)^2$

+ 10% Add

1363635