25 ACCOUNTING STANDARD – 29 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

"Failure is your best asset, complacency is your worst liability, and talent is your greatest capital."

1. NON-APPLICABILITY OF AS 29

AS 29 doesn't apply to:

(a) Executory contracts, except where the contract is onerous;

(b) financial instruments such as Shares, debentures, bonds etc.

(c) Deferred Tax Liabilities (AS 22);

(d) Lease Liabilities (AS 19, *Leases*);

(e) Employee benefit liabilities (AS 15, *Employee Benefits*); and

(f) Liabilities relating to Insurance contracts i.e. claims payable to customers.

(g) Provisions which are recognised as an adjustment to Assets such as Provision for depreciation, doubtful debts etc.

2. WHAT IS LIABILITY

Important Definitions:

- **Obligating Event:** an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.
- **Present Obligation:** if based on evidences available, its existence on the balance sheet date is considered probable i.e. more likely than not.
- **Possible Obligation:** if based on evidences available, its existence on the balance sheet date is considered not probable.

A Liability is a:

- Present Obligation of the Entity
- Arising from past events
- Settlement of which is possible only by outflow of resources (resources means any asset)

Past Events can create two types of Obligations:

- Legal obligation which arises from a contract or law
- Constructive Obligation which arises from Past Practices or Commitments. The occurrence of event creates valid expectations in other parties that "Entity will discharge its obligations". Valid expectations are created when an entity has committed or communicated to do something.

Examples of Past Events:

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.
3. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

3. WHAT IS A PROVISION?

Provision is a:

- liability
- of uncertain timing or amount
- whose outflow can be estimated reliably

Note: *If there is no past event, then there is no liability,* and no provision should be recognized.

Formulae for Liability	Formulae for Provision
Past Event + Present Obligation + Outflow + Certainty of settlement	Past Event + Present Obligation + Outflow probability more than 50% + Uncertain Amt. or Timing + Estimation

Some Examples on Liabilities and Provisions:

Nature of obligation	Recognition as provision as per AS 29 (Yes/No)	Reasons
Amount payable for utilities like electricity, gas, etc.	No	Amount payable for utilities represents an accrual of liability to pay for services that have been received. The amount and timing of payment can be determined with a reasonable certainty. It is a liability.

Goods or services received, but not invoiced	No	It is a liability. In such a case, amount and timing of payment would be driven by the terms agreed with the supplier.
Warranty obligations	Yes	Warranty obligation represents the additional cost that the seller may have to incur to rectify product defects. This is in the nature of provision as there is an uncertainty associated with the amount and timing of the liability.
Damages claimed by customer for Rs. 20 Lacs	Yes	If Entity is disputing the amount of claim then there is uncertainty of amount payable. It is a Provision. However, when court has passed the judgement for Rs. 15 Lacs, it will become the liability.

4. HOW TO MEASURE A PROVISION?

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

Methods to Measure the Provision

1. ***Expected value method***: this method is used when there are more than 2 possible outcomes with probability of each outcome is given. In such a case we need to weight each outcome by its probability. Amount of provision will be equal to the "Weighted Average Amount"
2. ***The most likely outcome***: This method is suitable in the case there are two possible outcomes. The outcome with highest probability is taken as the amount of Provision.

Discounting (Present Value)

- When the amount of provision is required to be settled beyond 1 year then provision should be measured at Present Value of future outflow.
- In such a case, interest cost shall be recognised to unwind the discount over the period in Profit and Loss account.
- Discount rate should be taken pre-tax always.
- If there is risk of actual outflow more than present value, the amount of present value shall be increased by % of risk factor.

Examples of Best Estimate:

An entity faces a single legal claim, with a 40 percent likelihood of success with no cost and a 60 percent likelihood of failure with a cost of ₹1 million. Expected value is not valid in this

case because the outcome will never be a cost of ₹600,000 (60 percent × ₹1 million); the outcome will either be nil or ₹1 million. AS 29 indicates that the provision may be estimated at the individual most likely outcome. In this example, it is more likely that a cost of ₹1 million will result and, therefore, a provision for ₹1 million should be recognised.
(Author Note - When there are only 2 outcomes use MOST LIKELY OUTCOME)

Other Important Points for Provision

1) Provision should not be made for "Future operating losses" since there is no past obligating event.

2) Provision should be recognised as soon as the obligating event takes place such as:

- Sale of Product with warranty, provision should be recognised on the date of sale
- PPE Installed with decommissioning cost, provision should be recognised as on PPE recognition date

3) Legal or Constructive obligation should be present as on Balance Sheet to create a Liability or Provision.

4) **Onerous Contracts:** Provision should be created at lower of:

a) Net Cost of Completing the Contract or
b) Penalty Cost of Cancellation of Contract

Note: Onerous contract means a contract in which the unavoidable cost (labor cost, material cost, variable production overheads) of meeting the obligation exceeds the expected benefits to be obtained. (e.g. Binding sale agreement or non-cancellable contract)

5) In case of Executory contracts, no provision is required.
Executory contracts are contracts under which

- Neither party has performed any of its obligations or
- Both parties have partially fulfilled their obligations to an equal extent.

6) When probability is given in the question then check if there is more than 50% chance of outflow then only provision is recognised.

7) If there is difficulty in estimating the provision amount due to unavailability of data or past experience, it is not justified to ignore the provision or not create the provision. Provision should be recognised based on industry data.

8) **Reimbursements:**

- If any expenditure is expected to be reimbursed by the other party and it is virtually certain to be received (more than 90% chance) then such reimbursement shall be recognised as a separate asset in the Balance Sheet.
- In the profit and loss account, provision can be presented net of reimbursement income.

- Amount of Reimbursement can never exceed the provision amount.

9) Provision should be reviewed at each balance sheet date and adjusted as per the current best estimate. If it is no longer required, then reverse the provision.

10) If the entity can avoid any future expenditure by its future actions, then NO provision is recognised for such expenditure. Example – future operating costs such as inspection of ships in the next 5 years, company can sale the ship before 5 years then no provision of inspection is required.

11) **Restructuring:**

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

Example: discontinuing a line of business or closure of one or two segments or operations

b) Provision for restructuring cost is required when:

- 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.

c) Restructuring provision should include only the direct expenditures such as staff termination cost, compensation to customers, lease termination penalty etc.

d) Following costs are not considered for restructuring provision:

- Training cost of employees
- Cost of relocating asset from one location to another
- Impairment cost

Example on Restructuring Cost:

Closure of a division – communication/ implementation before end of the reporting period

On 12th March, 20X1 (reporting date), the board of an entity decided to close down a division making a particular product. On 20th March, 20X1 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised at 31st March, 20X1 for the best estimate of the costs of closing the division.

IMPORTANT EXAMPLES ON PROVISION

1. Example on Legal requirement to fit smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by 30th September, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31st March, 20X1, the end of the reporting period

Present obligation as a result of a past obligating event – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion – No provision is recognised for the cost of fitting the smoke filters.

(b) At 31st March, 20X2, the end of the reporting period

Present obligation as a result of a past obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

2. Example Contaminated land and constructive obligation

An entity in the oil industry (having 31st March year-end) causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honoring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement- Probable.

Conclusion- A provision is recognised for the best estimate of the costs of clean-up.

3. Example Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, 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 – Probable.

Conclusion – A provision is recognised for the best estimate of ninety per cent 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. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted

4. Example on Warranties

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

Present obligation as a result of a past obligating event – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – Probable for the warranties as a whole.

Conclusion – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period

5. WHAT ARE CONTINGENCIES?

In Addition to Liabilities and Provisions, AS 29 deals 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 occurrence or non-occurrence of uncertain future event; or
- A present obligation from past event, but either:
    - The outflow of resources to satisfy this obligation is ***not probable*** (less than 50%), or
    - The amount cannot be reliably measured.

Treatment of Contingent Liability:

- Contingent liability shall not be recognised.
- It should be disclosed in Notes to Financial Statements.
- If the probability of outflow is less than 5% i.e. remote then disclosure is even not required.

Note:
When the entity is jointly and severely liable to settle the obligation along with another entity, in such case a part of the obligation which is expected to be met by other entity is treated as Contingent liability and the balance obligation is recognised either as Liability or Provision if it can be measured reliably.

Contingent Assets

A ***contingent asset*** is a ***possible asset*** arising from past events that will be confirmed by occurrence or non-occurrence of uncertain future events not fully under the entity's control.

Situations

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 the Contingent Asset
Possible but not probable (5% - 50% of probability)	Disclose the Contingent Liability	Disclosure is not required
Remote (less than 5% probability)	Disclosure is not required	Disclosure is not required

6. (MCQ's from ICAI Material)

1. Which of the following best describes a provision?
   (a) A provision is a liability of uncertain timing or amount.
   (b) A provision is a possible obligation of uncertain timing.
   (c) A provision is a credit balance setup to offset a contingent asset so that the effect on the statement of financial position is nil.
   (d) A provision is a possible obligation of uncertain amount.

2. X Co is a business that sells second hand cars. If a car develops a fault within 30 days of the sale, X Co will repair it free of charge. At 1st March 20X1, X Co had made a provision for repairs of ₹ 25,000. At 31st March 20X1, X Co calculated that the provision should be ₹ 20,000. What entry should be made for the provision in X Co's income statement for the month 31st March 20X1?
   (a) A charge of ₹ 5,000
   (b) A credit of ₹ 5,000
   (c) A charge of ₹ 20,000
   (d) A credit of ₹ 25,000

3. Which of the following item does the statement bellowed scribe?
   "A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control"
   (a) A provision
   (b) A current liability
   (c) A contingent liability
   (d) Deferred tax liability

4. Z Ltd has commenced a legal action against Y Ltd claiming substantial damages for supply of a faulty product. The lawyers of Y Ltd have advised that the company is likely to lose the case, although the chances of paying the claim is not remote. The estimated potential liability estimated by the lawyers are:
   Legal cost (to be incurred irrespective of the outcome of the case) ₹ 50,000 Settlement if the claim is required to be paid ₹ 5,00,000
   What is the appropriate accounting treatment in the books of Z Ltd.?
   (a) Create a Provision of ₹ 5,50,000
   (b) Make a Disclosure of a contingent liability of ₹ 5,50,000
   (c) Create a Provision of ₹ 50,000 and make a disclosure of contingent liability of ₹ 5,00,000
   (d) Create a Provision of ₹ 5,00,000

Answers	1	2	3	4
	a	b	c	c

Student Notes: -