RECOGNITION OF PROVISIONS

Present obligation as a result of past events.

CONDITION 1

&

Obligation - Reliable Estimate

CONDITION 2

&

Obligation settlement :- outflow of resources embodying future economic benefits.

CONDITION 3

↓

Probable

Chances of happening

Probable	Possible	Remote
75%	upto 50%.	less than 10%.

Possible → Contingent Liability

CONTINGENT LIABILITY

CASE I :- Condition 1 not satisfied.

→ Present Obligation ⟶ Possible obligation.

CASE II :- Condition 1 is satisfied but condition 2 or 3 is not satisfied.

2: reliable estimate cannot be made.

3: Possible outflow of resources embodying future economic benefits.

STUDENT NOTES

Disclose

CONTINGENT LIABILITY

1. A POSSIBLE Obligation, that arises from past events and
- existence of which will be confirmed only by happening or non- happening of one or more future events
- not wholly within the control of the enterprise.

2. A PRESENT Obligation that arises from past events, but not recognised as
- it is NOT PROBABLE that an outflow of resources embodying future economic benefits will be required to settle the obligation (possible outflow).
- A reliable estimate of the amount of obligation CANNOT be made.

RECOGNITION OF CONTINGENT LIABILITIES

- A Contingent Liability should NOT be recognised i.e. a provision should not made for it.
- A Contingent Liability should be DISCLOSED. If the chances are outflow of resources is REMOTE, even disclosure is not required.

NOTE:- In case of joint liability, the part of liability which is to be met by the other party is treated as Contingent Liability.

REVIEW OF CONTINGENT LIABILITY

- Should be reviewed at each B/S date.
- If outflow of resources becomes probable, provision should be recognised for such contingent liability.

Possible → Probable
recognise provision
Possible → Remote
donot even disclose

CONTINGENT ASSETS

- Is a possible asset that arise from the past events.
- Existence of which is confirmed by happening or non happening of uncertain future event.
- Neither recognised nor disclosed in financial statements, disclosed only in report of approving authority. → BOD's report.
- Reviewed at each B/S date.

STUDENT NOTES

ONEROUS CONTRACTS

- One where the unavoidable costs of meeting the obligations under the contract > the economic benefits expected to be received under it.
- Provision needs to be recognised & measured for onerous contract at the lower of:
  - Costs of Fulfilling the contract.
  - Compensation arising from failure to fulfil it.

Ultimate Learning

RESTRUCTURING & ITS PROVISION

- Is a program that is planned & controlled by management & materially changes either:
  - The scope of a business undertaken by an entity; or
  - The manner in which that business is conducted.

Eg:- Sale, Termination, Closure of business, changes in mgmt. structure.

- A Provision should be recognised only when the recognition criteria of provisions are met. No need to recognise a provision for sale of an operation until the enterprise has entered into a binding sale agreement.
- Restructuring provision includes only DIRECT EXPENSES arising from restructuring, which are
  - Necessarily entailed by the restructuring AND
  - Not associated with ongoing business activities of the enterprise.

Contract Terminate

Min. guar. contract

1·3·23 — 31·3·23 — 31·3·25

1·3·23 to 31·3·23 → Prov for rest ✗

31·3·23 to 31·3·25 → 2 years pay → because of term.

↓ because of restruct.

↓ $\boxed{\text{Prov for restruct.}}$ ✓

CA Tejas Suchak

Also mention :- If likelihood of outflow is remote then no need to disclose as a Contingent liab also.

STUDENT NOTES

be no outflow of the resources. Hence, no provision is required. The company will disclose the same as contingent liability by way of the following note:

"Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed copyrights and is seeking damages of ₹ 200 lakhs. However, the directors are of the opinion that the claim can be successfully resisted b y the company.

QUESTION 3 (RTP NOV 19) → HW

XYZ Ltd. has not made provision for warrantee in respect of certain goods due to the fact that the company can claim the warranty cost from the original supplier. Hence the accountant of the company says that the company is not having any liability for warrantees on a particular date as the amount gets reimbursed. You are required to comment on the accounting treatment done by the XYZ Ltd. in line with the provisions of AS 29

Answer:

As per para 46 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets", where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognized for the reimbursement should not exceed t he amount of the provision.

It is apparent from the question that the company had not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. However, the provision for warranty should have been made as per AS 29 and the amount claimable as reimbursement should be treated as a separate asset in the financial statements of the company rather than omitting the disclosure of such liability. Accordingly, it is viewed that the accounting treatment adopted by the company with respect to warranty is not correct.

QUESTION 4 (RTP MAY 20)

With reference to AS 29, how would you deal with the following in the annual accounts of the company at the Balance Sheet dates:

(i) ***An organization operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten percent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.***

STUDENT NOTES

(ii) During 2018-19 Ace Ltd. gives a guarantee of certain borrowings of Brew Ltd., whose financial condition at that time is sound. During 2019-20, the financial condition of Brew Ltd. deteriorates and on 31st Dec. 2019, it goes into liquidation. (Balance Sheet date 31-3-19).

***Answer**:*

(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 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. 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. Ten per cent of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

(ii) As per AS 29, for a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

The obligating event is the giving of the guarantee by Ace Ltd. for certain borrowings of Brew Ltd., which gives rise to an obligation. No outflow of benefits is probable at 31st March, 2019.Thus no provision is recognized.

The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

During 2019-20, the financial condition of Brew Ltd. deteriorates and finally goes into liquidation. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. At 31st March 2020, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Thus, provision is recognized for the best estimate of the obligation.

QUESTION 5 (RTP NOV 20)

(a) How will you distinguish Contingent Assets with Contingent Liabilities. Explain in brief.

(b) Alpha Ltd. has entered into a sale contract of ₹ 7 crores with Gamma Ltd. During 2018-19 financial year. The profit on this transaction is ₹ 1 crore.

Contract
manuf.
31·3·19
Delivery
30·4·

CA Tejas Suchak

Question 4 :-

Quote :- Recog. of Prov.

1. Present obl. as a result of p.e.
2. Probable outflow of resour. > f.e.b.
3. reliable estimate.

Analysis :- Company obligation of two types
1. Damage by oil extraction
2. Removal of oil rig & restoration of seabed.

⇒ Oil extraction - not started - no present obligation.
⇒ Oil rig is installed - Hence it will have to be removed later on and seabed will have to be restored.
→ ∴ Present obligation because of past event -
Probable outflow
Reliablable Estimate

Conclusion :- Provision recog → 90%. of the cost related to removal of oil rig & restoration of sea bed.

No Provision to be recog for oil extrac

Analysis:- Calamity → x, they donot owe anything to any thirdparty.
∴ there is no present obligation. Also the company at this moment is unable to arrive at a reliable est. of the amount of oblig.

Concl. since ① Pres. Ob x ② Rel. Est x → there is no need to recog Prov.

STUDENT NOTES

embodying economic benefits will be required to settle the obligation and (c) A reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognized.

From the above, it is clear that for the contingencies considered by the company, neither a present obligation exists because of past event, nor a reliable estimate can be made of the amount of the obligation. Accordingly, a provision cannot be recognized for such contingencies under the facts and circumstances of the case.

(b) As per 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 finalized, 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.

QUESTION 8 (RTP MAY 22)

Chaos Limited is in the process of finalizing its accounts for the year ended 31st March, 2020. It seeks your advice in the following cases:

(i) Chaos Limited has filed a court case in 2014-2015 against its competitors. It became evident to its lawyers during the year ended 31st March, 2020 that Chaos Limited may lose the case and would have to pay ₹ 3,00,000 being the cost of litigation. No entries/provisions have been made in the books.

(ii) A new regulation has been passed in 2019-2020 by the healthcare ministry to upgrade facilities. Deadline set by the government is 31.03.2021. The company estimates an expenditure of ` 10,00,000 for the said upgrade.

(iii) The company gives one year warranty for its healthcare equipment under the contract of sale that it will make good any manufacturing defect by repair or replacement. As per past experience, it is probable that there will be 1% such cases and estimated cost of repair / replacement is estimated at 10% of such sale value. During the year, the company has made a sale of ₹ 5 crores. Kindly give your answer for each of above with proper reasoning according to the relevant Accounting Standard. Also state the principles for recognition of provision, as per AS 29.

STUDENT NOTES

***Answer**: Principles for recognition of provisions: As per AS 29, "a provision shall be recognised when:*

a) an entity has a present obligation (legal or constructive) as a result of a past event;

b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognized."

<u>Accounting treatment under the given scenarios:</u>

(i) On 31st March, 2020, since it is evident to the lawyer that Chaos Limited may lose the case and also a reliable estimate of the outflow can be made as ₹ 3,00,000, there is a present obligation. Hence, provision should be recognized for ₹ 3,00,000 for the amount which may be required to settle the obligation.

(ii) Under new regulation, an entity is required to upgrade its facilities by 31st March, 2021. However, on 31st March, 2020, i.e. at the end of the reporting period, there is no obligation because there is no obligating event either for the costs of upgrading the facilities or for fines under the regulations. Hence, no provision should be recognized on 31st March, 2020 for upgrading the facilities by 31st March, 2021.

(iii) The obligating event is the sale of health care equipment with a warranty, which gives rise to a legal obligation. Here, an outflow of resources embodying economic benefits in settlement is probable for the warranties as a whole. Hence, a provision is recognized for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period as follows:

Probability of warranty cases for the entity where repair/replacement may be required as per past experience = 1% of ₹ 5,00,00,000 = ₹ 5,00,000

Estimated cost of repair / replacement = ₹ 5,00,000 x 10% = ₹50,000. → Provision

QUESTION 9 (RTP NOV 22)

Chaos Limited is in the process of finalizing its accounts for the year ended 31st March, 2022. It seeks your advice in the following cases:

(i) Chaos Limited entered into an agreement to supply 1 lac face masks to D Limited by 30th April, 2022 failing which it will have to pay a penalty of ₹10 per item not supplied. On 31st March, 2022 Chaos Limited assessed that it could only supply 50,000 face masks to D Limited by 30th April, 2022.

(ii) Chaos Limited has filed a court case in 2014-2015 against its competitors. It is evident to its lawyers that Chaos Limited may lose the case and would have to pay ₹ 3,00,000 being the cost of litigation. No entries/provisions have been made in the books.