PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

AS 29

AS-29 prescribes the guidance in respect of recognition, measurement and disclosures of provisions, contingent liabilities and contingent assets. The standard clearly defines the role of management while making an estimate for creating provisions and the auditors to vouch for the correctness or otherwise of the estimate made by the management. This ensures that manipulations do not take place at the time of creation of provisions.

Where another Accounting Standard such as AS 7; AS 9; AS 15; AS 19 and AS 22 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of AS 29.

Liabilities	It 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.
Present Obligation	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 (>50%).
Possible Obligation	An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet is considered not probable (< 50%).
PROVISION	
Meaning	A Provision is a liability which can be measured only by using a substantial degree of estimation.
Recognition criteria (PARA 14)	A provision should be recognized when: → An enterprise has a present obligation as a result of past event. → It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. → And a reliable estimate can be made of the amount of obligation. If these conditions are not met, no provision should be recognized. *Example:* X Ltd sells refrigerators with a warranty of 6 months. The refrigerators would be repaired free of cost by X Ltd. if some problem arises during the next 6 months of sale. There is a present obligation for X Ltd because if some defect arises, X Ltd would need to incur expenses on repairs of the refrigerator. Thus, a provision is required to be made in the books of X Ltd.
Measurement of provisions	Amount recognized as provision should be the best estimate of expenditure required to settle the present obligation at the balance sheet date.
Determinants of best estimate (Illustrative)	❖ Judgement of the management of the enterprise. ❖ Experience of similar transactions ❖ Reports from independent experts ❖ Any additional evidence provided by events after the balance sheet date.
Notes	❖ Provision should not be recognized for future operating losses. ❖ Provision should be measured before tax ❖ Provision should not be discounted to its present value.

Exception: Discounting of provision for decommissioning, restoration and similar liabilities should be done as per the pre-tax discount rate as mentioned therein.

Example:
Z Ltd takes a building on lease for 10 years. The terms of the contract provide that Z Ltd must vacate the building in its original condition. Z Ltd expects that there is a likely cost of 10 lakhs to be spent at the end of 10 years for restoration.
Since there is a present obligation on X Ltd at the time of entering into the lease contract, provision to the extent of present value of this amount should be created

- Provision should be reviewed at each balance sheet date
- It should be adjusted to reflect the current best estimate
- If it is no longer probable that there will be outflow of resources, then provision should be reversed.

CONTINGENT LIABILITY

Meaning

It is :
→ A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the enterprise

OR

→ A present obligation that arises from past events but is not recognized because
- it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation OR
- A reliable estimate of the amount of the obligation cannot be made.

	Elements	Cases				
1.	Possible obligation	X	X	X	X	√
2.	Present obligation from past events	√	√	√	√	NA
3.	Expected outflow	√	√	X	X	NA
4.	Measurability (using substantial degree of estimation)	√	X	√	X	NA
5.	Whether it is Provision(P) or Contingent liability (CL)	P	CL	CL	CL	CL

Recognition

Contingent liability should not be recognized

Disclosure

Contingent liability should be disclosed
Exception:
The possibility of an outflow of resources embodying economic benefits is remote (i.e. no disclosure is even required in such case).

CONTINGENT ASSETS

Meaning

It is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of an enterprise.

Recognition	A contingent asset should not be recognized. Note: When the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
Disclosure	❖ Contingent asset should not be disclosed in the financial statements ❖ It is disclosed in the director's report.
REIMBURSEMENT	
Meaning	When some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (example through insurance contracts, indemnity clauses, supplier's warranty etc.), reimbursement should be recognized when and only when it is virtually certain that reimbursement will be received if the enterprise settles the obligation.
Valuation & Disclosure	❖ Reimbursement recognized should not exceed the amount of provision. ❖ In Balance Sheet, reimbursement should be presented as a separate asset. ❖ In the Statement of P&L, provision may be presented net of the amount recognized for reimbursement.
RESTRUCTURING	
Meaning	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 enterprise; or (b) the manner in which that business is conducted
Examples	❖ sale or termination of a line of business; ❖ the closure of business locations in a country or region or the relocation of business activities from one country or region to another; ❖ changes in management structure, for example, eliminating a layer of management; and ❖ fundamental re-organizations that have a material effect on the nature and focus of the enterprise's operations.
Whether provision required?	➢ A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in Para 14 are met. ➢ No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.
Inclusions & Exclusions	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 enterprise. 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.

ONEROUS CONTRACT	
Meaning	It is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the *lower* of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.
Example	An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2020 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user. Present obligation as a result of a past obligating event- The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation. An outflow of resources embodying economic benefits in settlement- When the lease becomes onerous, an outflow of resources embodying economic benefits is probable *Conclusion*-A provision is recognised for the best estimate of the unavoidable lease payments.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)*

At the end of the financial year ending on 31st December, 2020, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by Board of Directors. The possible outcome as estimated by Board is as follows:

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

Question 2

An engineering goods company provides after sales warranty for 2 years to its customers. Based on past experience, the company has been 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 (₹)
19th January, 2018	40,000
29th January, 2019	25,000
15th October, 2019	90,000

Calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2019 and 31st March, 2020. Also compute amount to be debited to Profit and Loss Account for the year ended 31st March, 2020

Question 3 *(RTP Nov 2018 & May 2019) (Similar)*

WZW Ltd. is in a dispute involving allegation of infringement of patents by a competitor company who is seeking damages of a huge sum of ₹ 1,000 lakhs. The directors are of the opinion that the claim can be successfully resisted by the company. How would you deal the same in the annual accounts of the company?

Solution

As per para 14 of AS 29, a provision should be recognized when

a) an enterprise has a present obligation 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 should be recognized.

A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. The possibility of an outflow of resources embodying economic benefits seems to be remote in the given situation, since the directors of WZW Ltd. are of the opinion that the claim can be successfully resisted by the company.

Therefore, the company shall not disclose the same as contingent liability. However, following note in this regard may be given in annual accounts of the company:

"Litigation is in process against the company relating to a dispute with competitor who alleges that the company has infringed patents and is seeking damages of ₹ 1,000 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company".

Question 4 *(ICAI Study Material / (RTP May 2021)*

AB Ltd. is in the process of finalizing its account for the year ended 31st March, 2020. The company seeks your advice on the following:

a) The company's sale tax assessment for assessment year 2017-18 has been completed on 14th February, 2020 with a demand of ₹ 5.40 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 ₹ 3.70 crore.

b) The company has entered into a wage agreement in May 2020 whereby the labour union has accepted a revision in wage from June 2019. The agreement provides that the hike till May 2020 will not be paid to employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September 2020.

Solution

a) Since the company is not appealing against the addition of ₹ 1.70 crore (₹ 5.40 crore less ₹ 3.70 crore), therefore, the same should be provided/ expensed off in its accounts for the year ended on 31st March, 2020. However, the amount paid under protest can be kept under the heading 'Long-term Loans & Advances / Short-term Loans and Advances' as the case may be along with disclosure as contingent liability of ₹ 3.70 crore.

b) The arrears for the period from June, 2019 to March, 2020 are required to be provided for in the accounts of the company for the year ended on 31st March, 2020 assuming that negotiations for hike in wages had already started in the year 2019-20 i.e. before the balance sheet date though the agreement was entered in May, 2020.

Question 5 *(RTP Nov 2021) / (ICAI Study Material)*

An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31st March 2020, 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 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 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 6

During 2018-19, A Ltd. gives a guarantee of certain borrowings of B Ltd., whose financial condition at that time is sound. During 2019-20, the financial condition of B Ltd. deteriorates and at 30 September 2019, B Ltd. goes into liquidation.
State whether a provision is required
(a) At 31 March 2019 (b) At 31 March 2020

Solution
(a) At 31 March 2019
Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.
An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2019.
Conclusion - No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 2020
Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.
An outflow of resources embodying economic benefits in settlement - At 31 March 2020, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
Conclusion - A provision is recognised for the best estimate of the obligation.

Question 7 *(RTP May 2020)*

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.

(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 at 31st Dec. 2019 it goes into Liquidation. (Balance Sheet date 31-3-19 & 31-3-20)

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 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 31 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 31 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 8

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2020. The enterprise has not fitted the smoke filters.
State whether a provision is required:-
(a) At the balance sheet date of 31 March 2020
(b) At the balance sheet date of 31 March 2021

Solution
(a) At 31 March 2020
Present obligation as a result of 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.

(a) At 31 March 2021
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

Question 9 *(RTP Nov 2021)*

A company incorporated as NPO under the Companies Act having main objectives to promote the trade by organizing trade fairs/exhibitions. When the company was organizing the trade fair and exhibitions it decided to charge 5% contingency charges for the participants/outside agencies on the income received from them by the company, while in the case of fairs organized by outside agencies, 5% contingency charges are levied separately in the invoice, the contingency charges in respect of fairs organized by the company itself are inbuilt in the space rent charged from the participants. Both are credited to income & expenditure account of the company.

The intention of levying these charges is to meet any unforeseen liability, which may arise in future. The instances of such unforeseen liabilities could be on account of injury/loss of life to visitors/exhibitors etc. due to fire, terrorist attack, stampede, natural calamities and other public and third party liability. The chances of occurrence of these events are high because of large crowds visit the fair. The decision to levy 5% contingency charges was based on assessment only as actual liability on this account cannot be estimated.

The following accounting treatment and disclosure was made by the company in its financial statements:

1) 5% contingency charges are treated as income and matching provision for the same is also being made in accounts.
2) A suitable disclosure to this effect is also made in the notes forming part of accounts.

You are required to comment whether creation of provision for contingencies under the facts and circumstances of the case is in conformity with AS 29

Solution

As per paragraph 14 of AS 29, a provision should be recognised when:

1. an enterprise has a present obligation as a result of a past event
2. it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and
3. a reliable estimate can be made of the amount of obligation.

If these conditions are not met, no provisions should be recognised.

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.

Question 10

CASE 1 Court Case

After a wedding in 2019-20, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2020, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2021, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2020

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised.

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

(b) At 31 March 2021

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation.

CASE 2 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.

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 an 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 balance sheet date.

CASE 3 Refund Policy
A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.
An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund
Conclusion - A provision is recognised for the best estimate of the costs of refunds

CASE 4 Staff Retraining
The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.
Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.
Conclusion - No provision is recognized

CASE 5 Refurbishment Costs - No Legislative Requirement
A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.
Conclusion - No provision is recognized.
The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

CASE 6 Refurbishment Costs – Legislative Requirement
An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.
Conclusion - No provision is recognised.
The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in above question. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

However, an obligation might arise to pay fines or penalties under the legislation after completion of three years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than three years.

Question 11 *(ICAI Study Material)*

Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 2019-20 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2020-21 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 2019-20 financial year. As on balance sheet date (31.3.2020), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position 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?

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 recognised. 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, 2020 and no profit had accrued for the financial year 2019-2020. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.5 crores.

Question 12 *(RTP May 2018) / (RTP Nov 2019)*

The company has not made provision for warrantee in respect of certain goods considering 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. Comment

Solution

As per AS 29, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised 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 recognised for the reimbursement should not exceed the 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 was viewed that the accounting treatment adopted by the company with respect to warranty is not correct.

Question 13

M/s. Shishir Ltd., a public Sector Company, provides consultancy and engineering services to its clients. In the year 2019-20, the Government set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2017 based on the recommendations of the commission. The company makes the provision of ₹ 1250 lakhs for pay revision in the financial year 2019-20 on the estimated basis as the report of the commission is yet to come. As per the contracts with client on cost plus job, the billing is done on the actual payment made to the employees and allocated to jobs based on hours booked by these employees on each job.

The company discloses through notes to accounts: "Salaries & benefits include the provision of ₹ 1250 lakhs in respect of pay revision. The amount chargeable from reimbursable jobs will be billed as per the contract when the actual payment is made."

The Accountant feels that the company should also book/recognize the income by ₹ 1250 lakhs in Profit & Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit. Comment on his opinion with reference to relevant AS.

Solution

As per AS 29, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised 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 recognised for the reimbursement should not exceed the amount of the provision Accordingly, potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists.

In this case, the provision of salary to employees of ₹ 1,250 lakhs will be ultimately collected from the client, as per the terms of the contract. Therefore, the liability of ₹ 1,250 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be matched with the reimbursable asset to be claimed from the client. It appears that the whole amount of ₹ 1,250 lakhs is recoverable from client and there is no significant uncertainty about the collection. Hence, the net charge to profit and loss account should be nil.

The opinion of the accountant regarding recognition of income of ₹ 1,250 lakhs is not as per AS-29 and also the concept of prudence will not be followed if ₹ 1,250 lakhs is simultaneously recognized as income. ₹ 1,250 lakhs is not the revenue at present but only reimbursement of claim for which an asset is created.

However the accountant is correct to the extent as that non- recognition of ₹ 1,250 lakhs as income will result in the understatement of profit. To avoid this, in the statement of profit and loss, expense relating to provision may be presented net of the amount recognized for reimbursement.

Question 14

Mini Ltd. took a factory premises on lease on 1.4.2019 for ₹ 2,00,000 per month. The lease is operating lease. During March, 2020, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2022.The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2022 should be provided in the accounts for the year ending 31.3.2020. Mini Ltd. seeks your advice

Solution

In accordance with AS 29 'Provisions, Contingent Liabilities and Contingent Assets', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous* as the economic benefit of lease contract for next 33 months up to 31.12.2022 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of ₹ 66,00,000 (i.e.2,00,000 p.m. for next 33 months).

Therefore, provision on account of ₹ 66,00,000 is to be provided in the accounts for the year ending 31.03.2020. Hence auditor is right.

PRACTICE QUESTIONS

Question 1

X Ltd. has its financial year ended 31.3.2020, fifteen law suits outstanding, none of which has been settled by the time the accounts are approved by the directors. The directors have estimated that the probable outcomes as below:

Result	Probability	Loss (₹)
For First ten cases		
Win	0.6	-
Loss-Low damages	0.3	90,000
Lose-High damages	0.1	2,00,000
For remaining five cases		
Win	0.5	-
Loss-Low damages	0.3	60,000
Loss-High damages	0.2	1,00,000

The directors believe that the outcome of each case is independent of the outcome of all the others. Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.

Solution

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

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

In this case, the probability of winning first 10 cases is 60% and for remaining five cases is 50%. In other words, probability of losing the cases is 40% and 50% respectively. According to AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the probability or possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore, disclosure by way of note of contingent liability amount may be calculated as under:

Expected loss in first ten cases = [₹ 90,000 x 0.3 + ₹ 2,00,000 x 0.1] x 10
= [₹ 27,000 + ₹ 20,000] x 10
= ₹ 47,000 x 10 = ₹ 4,70,000

Expected loss in remaining five cases = [₹ 60,000 x 0.3 + ₹ 1,00,000 x 0.2] x 5
= [₹ 18,000 + ₹ 20,000] x 5
= ₹ 38,000 x 5 = ₹ 1,90,000

Total contingent liability = ₹ 4,70,000 + ₹ 1,90,000 = ₹ 6,60,000.

Question 2 *(Inter Nov 2022) (5 Marks)*

At the end of the financial year ending on 31st 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.

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:

a) There is a present obligation arising out of past events but not recognized as provision.
b) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
c) The possibility of an outflow of resources embodying economic benefits is not remote.
d) 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 ₹ 12,00,000 + 10% of ₹ 20,00,000
	=	₹ 4,80,000 + ₹ 2,00,000
	=	₹ 6,80,000
Expected loss in remaining five cases	=	30% of ₹ 10,00,000 + 20% of ₹ 21,00,000
	=	₹ 3,00,000 + ₹ 4,20,000
	=	₹ 7,20,000

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 1,04,00,000 (₹ 6,80,000 x 10 + ₹ 7,20,000 x 5) as contingent liability.

Question 3 *(Inter Nov 2019) (5 Marks) / (RTP May 2023)*

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 (₹)
11th February, 2018	60,000
25th December, 2018	40,000
4th October, 2019	1,35,000

Calculate the provision to be made for warranty under AS-29 as at 31st March, 2019 and 31st March, 2020. Also compute amount to be debited to P & L account for the year ended 31st March, 2020.

Solution

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

As at 31st March, 2019 = ₹ 60,000 x .02 + ₹ 40,000 x .03
= ₹ 1,200 + ₹ 1,200
= ₹ 2,400

As at 31st March, 2020 = ₹ 40,000 x .02 + ₹ 1,35,000 x .03
= ₹ 800 + ₹ 4,050
= ₹ 4,850

Amount debited to Profit and Loss Account for year ended 31st March, 2020

Balance of provision required as on 31.03.2020	4,850
Less: Opening Balance as on 1.4.2019	(2,400)
Amount debited to profit and loss account	2,450

Note: No provision will be made on 31st March, 2020 in respect of sales amounting ₹ 60,000 made on 11th February, 2018 as the warranty period of 2 years has already expired

Question 4 *(ICAI Study Material)*

EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2020. The company seeks your advice on the following: The Company's sales tax assessment for assessment year 2017-18 has been completed on 14th February, 2020 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.

Solution

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 31st March, 20. The amount paid under protest can be kept in the books as an advance under the heading 'Loans and Advances' and disclosed along with the contingent liability of ₹ 2.10 crore.

Question 5

An airline is required by law to overhaul its aircraft once in every five years. The pacific Airlines which operate aircrafts does not provide any provision as required by law in its final accounts. Discuss with reference to relevant Accounting Standard 29.

Solution

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 overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts. Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts. Further, the enterprise can avoid the future expenditure by its future action, for example by selling the aircraft. However, an obligation might arise to pay fines or penalties under the legislation after completion of five years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than five years.

Question 6 *(RTP Nov 2020)*

Alpha Ltd. has entered into a sale contract of ₹ 7 crores with Gamma Ltd. during 2019-20 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2020-21 financial year. In case of failure of Alpha Ltd. to deliver within the schedule, a compensation of ₹ 2 crores is to be paid to Gamma Ltd. Alpha Ltd. planned to manufacture the goods during the last month of 2019-20 financial year. As on balance sheet date (31.3.2020), the goods were not manufactured and it was unlikely that Alpha Ltd. will be in a position to meet the contractual obligation. You are required to advise Alpha Ltd. on requirement of provision for contingency in the financial statements for the year ended 31st March, 2020, in line with provisions of AS 29?

Solution

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. Alpha Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Alpha Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation.
Therefore, Alpha Ltd. should provide for the contingency amounting ₹ 2 crores as per AS 29.

Question 7 *(Inter Nov 2020) (5 Marks) / (RTP Nov 2023)*

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

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.

Question 8 (RTP May 2021)

a) The company has not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. You are required to examine in line with the provisions of AS 29.

b) Explain whether provision is required in the following situations in line with AS 29:
   (i) There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation;
   (ii) There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.
   (iii) There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.

Solution

(a) As per provisions 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 the 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 can be said that the accounting treatment adopted by the company with respect to warranty is not correct.

(b)
   (i) There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation – Provision is recognised. Disclosures are required for the provision.
   (ii) There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources – No provision is recognised. Disclosures are required for the contingent liability.
   (iii) There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote – No provision is recognised. No disclosure is required.

Question 9

Saharsh Ltd. is engaged in manufacturing of electric home appliances. The company is in the process of finalizing its accounts for the year ended 31.3.2020 and needs your expert advice on the following issues in line with the provisions of AS 29:

a) A case has been filed against the company in the consumer court and a notice for levy of a penalty of ₹ 20 lakhs has been received. The company has appointed a lawyer to defend the case for a fee of ₹ 2 lakhs. 50% of the fees has been paid and balance 50% will be paid after finalisation of the case. There are 75% chances that the penalty may not be levied.

b) The company had committed to supply a consignment worth ₹ 1 crore to one of its dealers by the year-end. As per the contract, if delivery is not made on time, a compensation of 15% is to be paid on the value of delayed/lost consignment. While the consignment was in transit, one of the trucks carrying goods worth ₹ 30 lakhs met with an accident. It was however covered by Insurance. According to the surveyor's report, the policy amount is collectable, subject to 10% deduction. Before closing the books of accounts, the company has received the information that the policy amount has been processed and the dealer has also claimed the compensation for the consignment of goods worth ₹ 30 lakhs which was in transit.

Solution

a) 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 75% chances that the penalty may not be levied. Accordingly, Saharsh Ltd. should not make the provision for penalty. However, a provision should be made for remaining 50% fees of the lawyer in the financial statements of financial year 2019-2020.

b) Loss due to accident ₹ 30,00,000
Insurance claim receivable by company = ₹ 30,00,000 x 90% = ₹ 27,00,000
Loss to be recognised in the books for 2019-2020 ₹ 3,00,000
Insurance claim receivable to be recorded in the books ₹ 27,00,000
Compensation claim by dealer against company to be provided for in the books
= ₹ 30,00,000 x 15% = ₹ 4,50,000

Question 10 *(Inter July 2021) (5 Marks)*

A Limited sells goods with unlimited right of return to its customers. The following pattern has been observed in the Return of Sales:

Time frame of Return from date of purchase	% of Cumulative Sales
Between 0-1 month	6%
Between 1-2 months	7%
Between 2-3 months	8%

The Company has made Sales of ₹ 36 Lakhs in the month of January, ₹ 48 Lakhs in the month of February and of ₹ 60 Lakhs in the month of March. The Total Sales for the Financial Year have been ₹ 400 Lakhs and the Cost of Sales was ₹ 320 Lakhs. You are required to determine the amount of Provision to be made and Revenue to be recognized as on 31st March.

Solution

Amount of provision

The goods are sold with a right to return. The existence of such right gives rise to a present obligation on the company as per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets'. According to the standard, a provision should be created on the Balance sheet date, for sales returns after the Balance Sheet date, at the best estimate of the loss expected, along with any estimated incremental cost that would be necessary to resell the goods expected to be returned.

Sales during	Sales value (₹ in lacs)	Sales value (cumulative) ₹ (in lacs)	Likely returns (%)	Likely returns ₹ (in lacs)	Provision @ 20% (₹ in lacs) (Refer W.N.)
March	60	60	6%	3.60	0.720
February	48	108	7%	7.56	1.512
January	36	144	8%	11.52	2.304
Total				22.68	4.536

Revenue to be recognized

Revenue in respect of sale of goods is recognized fully at the time of sale itself assumed that the company has complied with the conditions stated in AS 9 relating to recognition of revenue in the case of sale of goods. As per AS 9, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

a) Seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
b) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods. AS 9 also provides that in case of retail sales offering a guarantee of 'money back, if not completely satisfied, it may be appropriate to recognize the sale but to make a suitable provision for returns based on previous experiences.

Therefore, sale of ₹ 36 lakhs, ₹ 48 lakhs and ₹ 60 lakhs made in the months of January, February and March will be recognized at full value. Thus, total revenue to be recognized for RS. 400 lacs for the year.

Working Note:

Calculation of Profit % on sales

	(₹ in lacs)
Sales for the year	400
Less: Cost of sales	(320)
Profit Profit mark up on sales (80/400) x 100 = 20%	80

Question 11 *(RTP May 2022)/ (RTP Nov 2022) (Similar)*

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 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.

Solution

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 recognised."

Accounting treatment under the given scenarios:

(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 recognised 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.

Question 12 *(Inter May 2022) (5 Marks)*

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 31st March,2022 and needs your advice on the following issues in line with the provisions of AS-29:

(i) On 1st 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 31st 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.

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.