

AS 29, Provisions, Contingent Liabilities and Contingent Assets

CA Raajnish Desai

Provisions, contingent liabilities and contingent assets

Even though its basic approach is similar to that of AS 4, this standard elucidates and comprehensively deals with the principles of measurement of provisions and contingencies with specific guidelines in situations of restructuring, onerous contracts etc. and makes certain significant departures from AS 4

Applicability

Mandatory in respect of accounting periods commencing on or after 1 April 2004 for all enterprises

All paras of AS 4 dealing with contingencies stand withdrawn except to the extent such paras deal with impairment of assets not covered by other Accounting Standards (e.g. provision for doubtful debt is still covered by AS 4)

Exclusion from scope

- **Does not cover provisions, contingent liabilities or contingent assets:**
 - **Resulting from financial instruments that are carried at fair value**
 - **Resulting from executory contracts **except** where the contract is onerous**
 - **Arising in insurance enterprises from contracts with policy-holders**
 - **Those covered by another standard e.g., depreciation, impairment of assets, construction contracts, employees' retirement benefits, leases, deferred taxes**

Provision

Provision is required for probable outflow on account of obligations existing on the balance sheet date, provided the amount of the outflow can be estimated reliably

**Present
obligation as a
result of a past
event i.e.
obligating event**

**Probable
outflow of
resources**

**Reliable
estimate**

Understanding provisions...

Present obligation

- **At the date of the balance sheet enterprise has no realistic alternative to settling the obligation**

Probable Outflow of Resources Embodying Economic Benefits

- **More likely than not to occur**
- **A chance of more than 50 per cent**

Reliable estimates

- **Extremely rare case that reliable estimate can not be made. Determine range of possible outcomes and estimate the provision**

Measurement of provisions

✓ **Best estimate of expenditure**

✓ **Should not be discounted to present value**

✓ **Uncertainty does not justify creation of excessive provisions or deliberate overstatement of liabilities**

Reimbursements

- Reimbursement (\leq provision) recognised only when **virtually certain**
- Treated as a separate asset

Changes in provisions

- ✓ **Reviewed at each balance sheet date and adjusted**

Provision - Examples

IOC Limited has 6,000 Company operated retail fuel outlets. Provisions for expected clean up costs (ground water contamination) when certain that a law requiring cleaning-up of land already contaminated has been enacted

- **The obligating event** is the contamination of the ground water resources because of the virtual certainty of legislation requiring cleaning up
- **Outflow of resources** embodying economic benefits in settlement is probable
- **Conclusion**

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

Provision - Examples

An offshore oilfield where its licensing agreement requires removal of the oil rig at end of production and restore seabed. 90% of the 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 balance sheet date, the rig has been constructed but no oil has been extracted

Provision - Examples

- Construction of oil rig is 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
- A provision is recognised for the **best estimate of 90%** of the 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 oil rig. The 10% of costs that arise through extraction of oil are recognised as a liability when the oil is extracted

Provision - Examples

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2017. The enterprise has not fitted the smoke filters

31 March 2017

- There is **no obligation** because there is no obligating event as at the balance sheet date either for the costs of fitting smoke filters or for fines under the new legislation.
- **No provision** is recognised for the cost of fitting the smoke filters

Provision - Examples

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2017; **otherwise penalties are prescribed**. The enterprise has not fitted the smoke filters

31 March 2018

- There is still **no obligation** for the costs of fitting smoke filters. However an obligation arises to pay fines or penalties under the legislation
- **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

Provision - Examples

**Staff retraining is required as a result of changes in the Income-tax system.
At the balance sheet date, no retraining 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 recognised

Provision - Examples

ABC Beverages sells fruit beverages in the market. There are on-going legal proceedings as a result of food poisoning from fruit beverages sold by the enterprise in 2015-2016

Till approval of the financial statements for the year 31 March 2016, the lawyers advise that it is probable that the enterprise will not be found liable. However, for 31 March 2017, lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable

Provision - Examples

As at 31 March 2016

- **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**

Provision - Examples

As at 31 March 2017

- **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 is **probable****

- **Conclusion**

A **provision is recognised for the best estimate of the amount to settle the obligation**

Provision – Examples

A manufacturer undertakes to make good manufacturing defects that become apparent within three years from the date of sale. On past experience it is more likely than not that there will be some claims under the warranty

A provision is required for the best estimate of the costs of making good under the warranty for sales upto the balance sheet date

Contingent liabilities

- **Present obligation** from past events

- Resource outflow neither probable nor remote or rare situation where reliable estimate cannot be made

- **Possible obligation** from past events

- Existence will be confirmed only by occurrence or non-occurrence of one or more uncertain future events not wholly within control of the enterprise

Contingent liabilities

- **If the outflow is not probable or if in the rare circumstance it cannot be estimated reliably, disclosure of relevant information is required as a contingent liability, unless the possibility of outflow is remote**
- **Though the standard does not define, we may take a level of below 5% possibility as remote**

Contingent liabilities - Examples

During 2015-16, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2015-16, the financial condition of Enterprise B deteriorates and at 30 September 2016 Enterprise B goes into liquidation

As at 31 March 2016

- **Obligating event** is the giving of the guarantee, which gives rise to an obligation
- **No outflow of benefits** is probable at 31 March 2006
- **Conclusion**

No provision is recognised. The guarantee is disclosed as a contingent liability since in most cases one should not consider the probability of any outflow on account of a legally valid guarantee as remote

Contingent liabilities - Examples

As at 31 March 2017

**Since the probability of the liability would in most such cases be plus 50%,
a provision should be made**

Recognition criteria – judgement

Only Indicative guidelines:

- **Virtually certain:** > = 95%
- **Probable (more likely than not):** > = 50%*
- **Possible:** < = 50%
- **Remote:** < = 5%

* In the standard

Mathematical percentages have been ascribed only to give indication of the levels

Provisions and contingent liabilities

<p>There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.</p>	<p>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources</p>	<p>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</p>
<p>A provision is recognised</p>	<p>No provision is recognised</p>	<p>No provision is recognised</p>
<p>Disclosures are required for the provision</p>	<p>Disclosures are required for the contingent liability</p>	<p>No disclosure is required</p>

Contingent assets

Possible asset that arises from past events, existence of which will be confirmed only by occurrence or non-occurrence of uncertain future events not wholly within control of the enterprise

NOT ACCOUNTED FOR

Recognition criteria – asset, liability or contingency?

Asset	Virtually certain	Recognise
Contingent asset	Probable	Disclose in report of approving authority
	Possible	Do not disclose
	Remote	Do not disclose
Estimated Liability	Probable	Recognise as provision
	Possible	Disclose as contingent liability
	Remote	Do not disclose

Restructuring

- It is a programme that materially changes scope of business or manner in which business is conducted
- Provision only when recognition criteria for provisions met

Sale of a line of business

No obligation arises for sale of an operation until binding sale agreement. Provide when binding agreement of sale is entered into

Closure of business locations

Relocation of business activities from one country/region to another

Changes in management structure

Fundamental re-organisations

Provide only when the actual action takes place except in case of resulting onerous contracts, if any - However these may indicate impairment of certain assets

Future Operating Losses

- **Provisions should not be recognised**
- **However these indicate that certain assets may be impaired**

Application – onerous contracts

- **Definition:** contract under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent
BUT in which unavoidable estimated costs of meeting the obligation exceed the economic benefits expected to be received
- Onerous present obligation under the contract should be recognised as a provision
- Measurement at the lower of:
 - The fulfilment cost; and
 - Any compensation or penalties arising from failure to fulfil
- *If impairment losses on assets dedicated to the onerous contract have been recognised, provide for onerous obligation only if it is additionally required*

Onerous contracts

	Variable Cost	Fixed cost	Total
Costs to fulfill contract	85	35	120
Revenue from contract			90
Unavoidable total cost of meeting the contract	-		30
Penalty to terminate contract			40

Provision for onerous contract

(A) 30

~~(B) NIL~~

For determining unavoidable cost of meeting the contract, consider only direct variable cost. In this case it is lower at 85 against 90 of revenue. Hence no provision is required.

Disclosure - light is the best policeman!

For each class of provision

- **Brief description of nature of obligation and expected timing of outflows**
- **Indication of uncertainties about those outflows (and major assumptions where required)**
- **Amount of any expected reimbursement**

Disclosure – roll-forward by category

For each class of provision

Opening balances

+ additional provisions recognised (including increases to existing provisions)

- amounts used (i.e. incurred and charged against the provisions)

- unused amounts reversed

= ending balances

Disclosure

For each class of contingent liability disclosed

- **A brief description**
- **Estimate of financial effects**
- **Indication of uncertainties relating to any outflow**
- **Possibility of any reimbursement**

Where any of the above information is not disclosed because it is not practicable to do so, that fact should be stated

'Prejudicial to interest' – exception to disclosure

Disclosure not required in the **EXTREMELY RARE** circumstances when disclosure would seriously prejudice the position of the entity in a dispute with another party

- Disclose the general nature of the dispute and the fact that, and reason why, the information has not been disclosed
- Due care needs to be exercised to ensure that exception is not misused to avoid disclosures

Thank you

Questions ?