AS 29, Provisions, Contingent Liabilities and Contingent Assets

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

All paras of AS 4 dealing with contingencies stand withdrawn except to the extent such paras deal with impairment of assets not covered by other Accounting Standards (e.g. provision for doubtful debt is still covered by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 liabilites 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 (< / = provision) recognised only when virtually certain
- Treated as a separate asset

Expected disposal of assets

- Gains from expected disposal should not be taken into account
- Recognised only as per the time specified in accounting standard dealing with the relevant asset

Changes in provisions

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

Provision - Examples

Provisions for expected clean up costs when virtually certain that a law requiring cleaning-up of land already contaminated will be enacted

- The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up
- Outflow of resources embodying economic benefits in settlement is probable
- onclusion

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

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

(Continued)

- 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 *(Continued)*

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2007. The enterprise has not fitted the smoke filters

31 March 2007

- 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 legislation.
- No provision is recognised for the cost of fitting the smoke filters

Provision - Examples *(Continued)*

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2007; otherwise penalties are prescribed. The enterprise has not fitted the smoke filters

31 March 2008

- 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 *(Continued)*

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 *(Continued)*

Legal proceedings as a result of food poisoning from products sold by the enterprise in 2005-06

Till approval of the financial statements for the year 31 March 2006, the lawyers advise that it is probable that the enterprise will not be found liable. However, for 31 March 2007, lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable

As at 31 March 2006

- 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 *(Continued)*

As at 31 March 2007

- 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

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

- 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 2005-06, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2006 Enterprise B goes into liquidation

As at 31 March 2006

- 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 *(Continued)*

As at 31 March 2007

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

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

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 Possible Remote	Disclose in report of approving authority Do not disclose Do not disclose
Estimated Liability	Probable Possible Remote	Recognise as provision Disclose as contingent liability 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 (discussed later) - 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

Small and Medium Sized Companies are exempted from the above disclosures

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

Small and Medium Sized Companies are exempted from the above disclosures

Disclosure

For each class of contingent liability disclosed (applicable to all enterprises)

- 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

Differences with IAS 37

	IAS 37	AS 29
Discounting	Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation	The Indian standard prohibits discounting
Contingent assets	Requires certain disclosures in respect of contingent assets where an inflow of economic benefits is probable	Does not require or permit such disclosure. Contingent asset is usually disclosed in the report of the approving authority where an inflow of economic benefits is probable

Differences with IAS 37

	IAS 37	AS 29
Constructive obligation	Provisions are required for both legal and constructive obligations	As per an appendix to the standard, it does not deal with constructive obligations

Thank you