AS-11 “The Effects of Changes in Foreign Exchange Rates”

AS-15 “Employee Benefits”

AS-19 “Leases”

AS-29 “Provisions, Contingent Liabilities and Contingent Assets”

Presented By:
CA Shripal Shah
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AS-11 “The Effects of Changes in Foreign Exchange Rates”

Key Concepts

- **Reporting Currency**
- **Monetary items-** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.
- Issue – Advance paid for procurement of goods or services?
- **Answer** – Non-monetary item
- **Non-monetary items** – Example, Investment in Equity Shares.
- Issue – Treatment of investment in quoted equity shares, unquoted preference shares etc?
- **Answer** – Investment in equity shares (whether quoted or unquoted) is non-monetary item whereas investment in unquoted preference shares is monetary item
- **Integral operations and Non-integral operations**

Initial Recognition:

- Exchange rate at the date of transaction
- No differentiation between monetary and non-monetary items

Question:

Can Company book all import purchase at BOE rate ? what to follow when it has given advance to supplier? does AS 11 require to follow the RBI rates for booking of Purchase and Sales?

Answer:

a. Yes. Rate notified by regulatory authorities can be adopted and needs to be followed consistently.

b. Advance to supplier – rate applied by bank

c. AS-11 does not mandate the entity to adopt RBI rate.

d. Should be an accounting policy

Balance sheet date reporting:

- Monetary items – closing rate unless the rate is unrealistic
- Non-monetary items carried at historical cost – rate at the date of transaction
- Non-monetary items carried at fair value- rate prevailing on the date when such fair values have been determined

Issue - Whether any adjustment could be made on the closing rate after the balance sheet date, to give effect to reduced or increased rate?

Answer - Unless the facts are known on the reporting date that the rate adopted is highly unrealistic, hindsight should not be used and hence, no adjustment needs to be made to give effect to reduced or increased rate subsequent to balance sheet date.

Recognition of Exchange difference:

- Settlement or restatement of Monetary item – As expense or income
- Exception – **Settlement of** monetary item that is in substance net investment in non-integral operations – Accumulated in FCTR

Issue - Extension of loan to subsidiary?

Answer – Though loan is extended or keeps getting extended at each maturity, the settlement is construed as always planned, and therefore, loan to subsidiary the tenure of which is getting extended, do not form part of net investment.

Classification of foreign operations:

Integral operations

- Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.
- Translation – as if transactions have been carried out by reporting enterprise.
- Translation rate – rate at the date of transaction or the rate that approximate the actual rate i.e. **monthly or weekly rate**

Non-Integral Operations

- Assets and liabilities, both monetary and **non-monetary**, are to be translated at closing rate
- Income & Expenses – rate at the date of transaction. Average rate **for the period** may be used.
- Resulting difference – accumulated in FCTR

Reclassification of foreign operations:

- From integral to non-integral – Exchange differences arising from translation of **non-monetary assets -** FCTR
- From non-integral to integral- Exchange difference arising from translation of **non-monetary items** – Adjustment to historical cost.

Forward Exchange Contracts

- **Held to mitigate foreign currency risk**
- Premium or discount at the inception of forward contract – Amortisation
- Exchange difference – in P & L, separately from premium or discount
- Profit or Loss on cancellation or renewal – in P & L
- Assets or liabilities existing on books

- **Held for trading or speculative purpose**
- Premium or discount – ignored
- Marked to Market at each reporting date

- **Highly probable forecast transactions** –
- Not covered under AS 11
- GN on accounting for derivatives

Question:

Mr. A bought a forward contract for three months of US $ 1,00,000 on 1st December at 1 US $ = Rs. 77.10 when exchange rate was US $ 1 = Rs. 76.92. On 31st December when he closed his books, exchange rate was US $ 1 = Rs. 77.15. On 31st January, he decided to sell the contract at Rs. 77.18 per dollar. Show how the profits / loss from contract will be recognised in the books.

(In Lakhs)

Answer:

Non-speculative:

Date	Particulars	Dr.	Cr.
1st Dec	Foreign Currency Receivable Forward Contract def premium To Forward Contract Payable	76.92 0.18	 77.10
31st Dec	Foreign Currency Receivable To P & L	0.23	 0.23
31st Dec	P & L To Forward Contract def premium	0.06	 0.06
31st Jan	Forward Contract Payable Bank To Foreign Currency Receivable To Profit and Loss	77.10 0.08	 77.15 0.03
31st Jan	P & L To Forward Contract def Premium	0.12	 0.12

Answer:

Speculative: Assuming two months forward contract rate is $1=Rs. 78

(In Lakhs)

	Particulars	Dr.	Cr.
31st Dec	Foreign Currency Asset Receivable To P & L	0.90	 0.90
31st Jan	P & L Bank To Forward Contract Asset Receivable	0.82 0.08	 0.90

In both computations, Profit remains the same i.e. 0.08 lakhs.

Important Disclosures:

- Use of currency other than reporting currency with justification
- Change in classification of foreign operations

Transitional Provisions (Para 46 and 46A):

- Gives irrevocable option to treat exchange difference on long term monetary items as adjustment to carrying value of depreciable asset or in other cases, accumulate it in Long term foreign currency monetary item translation difference account
- Companies - Difference to be amortised over balance period of long-term asset/liability, but not beyond 31st March 2020
- Entities other than companies – option open even beyond 31st March 2020
- Long term Monetary Item – Term of 12 months or more at the date of **origination** the asset or liability

Issues:

Adjustment to depreciable asset – exchange loss or gain?

Answer - Discussed in answer to one of the questions, included in subsequent slides.

Exchange difference arising on loan given to subsidiary which is being extended from time to time?

Answer - The tenure should be considered on the date of origination of the asset. Subsequent extension is not relevant.

Questions:

A Company had imported raw material s amounting $ 60,000 on 5th January, 2020 when the exchange rate was RS. 73 per dollar. The company had recorded the transaction in the books at the above-mentioned rate. The payment for such transaction was made on 5th April 2020 when the exchange rate was Rs. 74 per Dollar. On 31st March 2020, exchange rate was Rs. 75. The company passed an entry on 31st march adjusting the cost of raw material consumed for the difference between Rs. 74 and Rs. 73 per Dollar.

As per AS-11 is the accounting treatment of the company correct?

Answer:

No. The exchange difference can not be adjusted against cost of RM consumed. Exchange difference needs to be separately debited in P & L and disclosed as required under AS 11

At the time of audit, Auditor see that different entity follow different sources for restatement of monetary item at the year end. Like Vadilal's rate, Group entity's rate, Custom rate, RBI Rate etc. Which source would be preferable and if different companies follows different sources whether there is any non-compliance reporting under AS 11?

Answer:

- A. Ideally, restatement rate should be taken as stipulated by bank with whom entity regularly deals for its foreign exchange transactions.
- B. rate notified by regulatory agencies may be considered
- Rate adopted by other entities should not be considered. If adopted, would be departure from AS 11. Group entity rate may be adopted if entity is privy to facts and circumstances under which a rate has been adopted. Further, entity needs to see whether it can corroborate or relate its own foreign currency transactions with those of the group. However, group rate should be avoided as it might be highly subjective for the entity.

Questions:

ABC Ltd. prepare financial statement as at 31st March, 2020 showing Exports trade receivables $ 1,50,000, Advance received from Trade receivable $ 200,000. Trade Payable -import $ 2,50,000 and advances given to trade Payable $ 3,00,000. ABC Ltd. restated Trade Receivable and advance received from trade receivable at the rate of Custom Rs. 76.70. It has restated its trade payable and advance to supplier at the rate of its group entity Rs. 77. Whether accounting treatment given by ABC ltd. is correct?

Answer:

- No. Realised or paid advance would be considered at the rate applied by bank, it being non-monetary item
- IFRIC 22 published by IASB effective from 1st January 2018
- Restatement of net trade receivables and payables to be done preferably on buying and selling rate respectively as communicated by bank.

Could you please explain again why advance to supplier is a non monetary item

Answer:

In my view, the entity gives advance to supplier to receive specified quantity of goods and not to receive money, and therefore such advance is non-monetary item.

Questions:

We have ECB for using for WC and for doing leasehold improvement. Now at the year-end can we capitalise the translation gain/loss under leasehold improvement cost.

Answer:

- Exchange loss arising from foreign currency borrowings (i.e. ECB for leasehold improvement, in this case) to the extent that they are regarded as an adjustment to interest costs, can be added to the leasehold improvement cost, provided the asset is a qualifying asset.
- Exchange gain on translation could be adjusted to the cost of an asset, to the extent of exchange loss earlier added to the cost of an asset, provided the asset is still qualifying asset (construction period is not over). Any excess gain should be accounted in Profit and Loss account/statement.
- Paragraph 4(e) of AS 16 may be referred to.

Questions:

Can a Company use BOE rate for Import of goods and RBI rate for Export of goods and services? Is there a violation under AS 11?

Answer:

This should be a matter of accounting policy for recognition of all foreign exchange transactions. In my view, if BOE rate is used for imports, the Bill of Lading rate needs to be used for export. Both are notified by same regulatory authority i.e. custom authorities. RBI rate should not be used for exports if BOE rate is used for imports. If different rates are used, it would not portray the accurate picture for entity's aggregate foreign exchange transactions, and it may be viewed as departure from AS-11.

Advance received are to be restated at 31 March rate?

Answer:

No. The settlement would occur through sale of goods and not through actual payment of advance. Hence, in my view, such advance is non-monetary item and need not be restated. If sale order gets cancelled, in such case, advance partakes the character of liability and the settlement of which needs to be made in cash. Hence, upon cancellation of order, advance received turns into monetary item, if it is refundable.

AS-15 “Employee Benefits”

Key Concepts

Defined Contribution Plans

- Pays fixed contribution
- Does not have further obligation if fund does not hold sufficient assets
- Investment and Actuarial risks are not assumed
- In substance, settlement of employee benefit

Issue- Administered PF Plans through Trust where interest rate is assured?

Answer - When guarantee is embedded through assured interest rate, the entity carries obligation to make good shortfall if the return on assets is not sufficient. In such case, the above-referred conditions related to defined contribution plans are not met and thus, PF plan would be treated as defined benefit plan

Current Service Cost – increase in obligation resulting from employee service in current year

Interest Cost – effect of unwinding

Past Service Cost - arises from the introduction or change to Post employment benefit plans or other long-term employee benefits

Key Concepts

Actuarial gains and losses

- Experience Adjustments
- Change in Actuarial Assumptions

Issue- if there are material experience adjustments every year, what does it indicate?

Answer - This would generally indicate that the data submitted by entity are not reliable and hence, risk assessment procedures by auditors may require to factor in the probability of increased risk.

Compensated Absences

- Accumulating – expected cost to be recognised as the employee renders service
- Non-accumulating – when absences occur

Issue- Whether provision of PF needs to be made on Leave encashment liability, if it forms part of salary/wages as per entity's policy?

Answer -Yes, Provision of PF needs to be made though the amount provided for, will initially not get credited to individual accounts of the employees.

Recognition and Measurement

Defined Benefit Plans –

- Management's responsibility
- Services of qualified actuary
- Actuarial valuation for each plan separately
- Defined benefit obligation – Presentation on Gross basis
- Defined Benefit Liability – on Net basis

Defined Benefit Obligation –

- With sufficient regularity
- Detailed Actuarial valuation at intervals not exceeding 3 years
- The most recent valuation report is updated to reflect material transactions and other material changes in circumstances (including changes in interest rates) between the date of valuation and balance sheet date.

Past Service Cost –

- If benefits have already been vested – Charge to P & L
- If not vested – On straight line basis over a period until the benefits are vested

Recognition and Measurement

Termination Benefits –

- Recognition is on the same lines as that of provisions as given in AS 29

a) Present obligation as result of past events;

b) Probable that outflow of resources will be required to settle the obligation

c) Reliable estimate can be made

- To be recognised as expense including VRS expenses
- If employee benefits are payable regardless of the reason of employee departure-Defined Benefit Plan

Actuarial Valuation –

- Projected Unit Credit Method – To be used for both, DBO and plan assets?
- **Answer** - PUC applies to DBO. Plan assets are measured at fair value and communicated by plan manager.
- Discounting of whole of DBO even if part falls due within 12 months
- Actuarial assumptions – neither imprudent nor excessively conservative
- Discount rate – Govt Bond yield rate

Issue - An auditor has received an actuarial valuation report from an entity wherein one of the assumptions is : retirement age is 60 whereas company's current policy indicates retirement age is 58. The company is contemplating to change its retirement policy to 60 years. Whether auditor should accept the actuarial valuation report and issue clean report?

Answer - Yes. Auditor should accept actuarial valuation report as the company is contemplating to change its retirement policy to 60 years. Further, the standard states that actuarial assumptions should be neither imprudent nor excessively conservative and hence, contemplated retirement age of 60 years should be accepted.

Defined benefit Plans –

- SMC and level II and level III entities employing more than 50 employees– need not apply para 50 to 116 in respect of accounting. However, liability needs to be determined on actuarial basis.

Disclosures –

- Illustrative disclosures have been given in the standard
- For each major plan assets, the percentage or amount that each category constitutes of the fair value of total plan assets

Transitional Provisions

Defined benefit Plans –

- If transitional liability is more than which would have been recognised under pre-revised AS-15:
- Irrevocable choice to adjust excess in opening reserves or recognise as exp over a straight line basis over a period of 5 years

Issue – An entity adopted AS-15 for the first time in year 2019-20. whether transitional provisions would apply?

Answer - Presuming that the entity did not adopt pre-revised AS 15, the benefit of transitional provisions would not be available. Any resultant effect needs to be treated as prior period error and required to be dealt with in accordance with principles enunciated in AS 5.

Questions

A Ltd., is in pharma industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of Rs. 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs. 2 lakhs instead of Rs. 5 lakhs. The average remaining life of the employee is estimated to be 6 years. You are required to advise the company.

Answer:

- Transitional provisions would not apply as said provisions deals with liability only and not surplus
- Surplus would be recognised immediately as income in P & L
- Disclosure of change in accounting policy

A co. having only 2 employees and this is their first year of employment in the co.and does not intend to make prov. for retirement benefits.

How the report should be qualified by auditors ? Does it also to be included in key audit matters? Does the answer changes considering the materiality concept?

Answer:

- AS framework – AS applies to items which are material
- If amount is material in overall context of FS – modification required
- KAM is not substitute for modification or EOM

Questions

How to account for sick and casual leaves which are not encashable but are carried forward and are allowed to be used in next years?

Answer:

- No differentiation between encashable and unencashable leave as far as accounting angle is concerned
- Accumulating and Non vesting. Obligation exists and provision should be made as part of cost of services
- Accounting – if short term i.e. can be c/f for one year - Expected cost based on expectation of number of days that would be availed
- If long term - other long term employee benefits – actuarial valuation

Actuary has issued report on the presumption of going concern, however the management has decided to close the company in the fy 20-21. had the fact been known to actuary whether the valuation would have been different.

Answer:

In my view, the actuarial valuation would have been different if such facts would have been known to actuary. In such case, the actuarial valuation would have contained, among other things, remeasurement of employee benefits obligations on account of curtailments and settlements of plans.

Questions

Is it mandatory to have actuarial valuation done for accounting for gratuity?

Answer:

- Yes, in case of SMC and level II or level III non-corporate entities whose average number of persons employed during the year is 50 or more. Such entities need to actuarially determine the liability (unless the amount involved is immaterial), and method used for actuarial valuation should be projected unit credit method. Actuarial Valuation is not mandatory for above-referred entities whose average number of persons employed during the year is less than 50. Such entities may calculate and account for the accrued liability under defined benefit plans by reference to some other rational method.
- Non-SMC and Level I non corporate entities – actuarial valuation is mandatory unless amount involved is immaterial.
- Actuarial valuation may be carried out by the entity on its own or get it done through independent actuary.

AS-19 “Leases”

Key Concepts

Inception of lease -

- Earlier of the date of lease agreement and the date of commitment to the principal provisions of the lease.

Lease term –

- Non cancellable period for which the **lessee** has agreed to take on lease an asset for specified period of time
- Option to continue the lease
- Reasonable certainty at the **inception** of lease

Non-cancellable period – which is cancellable only:

- On the occurrence of some remote contingency
- With permission of lessor
- New lease with same or equivalent asset with same lessor
- Additional amount clause which makes lease period certain

Key Concepts

Issue- A lease agreement to use an asset for 3 years. However, there is no lock in period and lease can be terminated by either party with 15 days' notice? What would be the lease term?

Answer:

- There is no concept of lock in period in AS 19
- Mere existence of clause permitting termination of lease agreement upon notice does not by itself amount to a cancellable lease
- Entire contracted period needs to be considered as lease term i.e. 3 years unless the lease is cancellable on account of factors mentioned in para 3.4 of the standard.

Minimum Lease Payments

- Includes Purchase option - if reasonably certain – The said option needs to be at the price sufficiently lower than the fair value at the date the option becomes exercisable

Economic life – use by one or more users

Useful Life- use by the lessee

Residual value- Fair value at the end of lease term

Guaranteed Residual value-

In case of lessee – any amount guaranteed by lessee that could, in any event, becomes payable

In case of lessor – any amount guaranteed by lessee or third party on behalf of lessee

Key Concepts

Gross Investment in Lease

- MLP + unguaranteed residual value

Unearned finance income - Difference between GI and PV

Net Investment- GI minus Unearned finance income

Classification of Lease-

- Substance over form
- At the inception of lease

Finance Lease – Transfer of risk and rewards incidental to ownership

Other Factors –

Transfer of lease asset at the end of term

Option to purchase at sufficiently lower price than fair value

Lease is for major part of economic life

PV of MLP at least equals to FV at the inception

Leases in Financial Statements of the Lessee

Finance Lease -

- Recognition at the inception of the lease
- PV of MLP

Issue – Lease agreement date is 1st April. Asset made available for use on 1st May. When lease could be recognised?

Answer - Lease could be recognised at the time the lessee is vested with rights to use an asset i.e. at the time of the asset is made available for use. In this case, lease accounting becomes practically feasible on 1st May.

Issue – Fair Value of leased asset is Rs. 10 crores. PV of MLP is Rs. 8 crores. Which amount to be recognised as an asset?

Answer - An asset is to be recognised at Rs. 8 crores.

Issue – Lease is for a period of 8 years. The economic life of the asset is 15 years. The lessee has an option to purchase the asset at the end of lease term. Whether leased asset would be depreciated over a period of 8 years or 15 years?

Answer - If exercise of purchase option is certain at the inception of lease and the asset could be purchased at the price sufficiently lower than the fair value at the date option becomes exercisable, lease term would be for 15 years and asset needs to be depreciated over 15 years. In respect of cases other than above, the lease period of 8 years needs to be considered.

Leases in Financial Statements of the Lessee

Operating Lease -

- Lease payments on Straight line basis or other systematic basis

Issue- A lease agreement to use an asset for 3 years. The lease rentals are scheduled to increase by 10% at the end of each year. However, there is no lock in period and lease can be terminated by either party with 15 days' notice? How lease rentals would be accounted for?

Answer - As discussed in earlier slides, the lease term would be 3 years and straight lining for 3 years needs to be done.

Leases in Financial Statements of the Lessor

Finance Lease -

- As a receivable at net investment amount
- Finance income to be recognised on lease rentals
- Review of unguaranteed residual value

Issue – Unguaranteed residual value originally estimated at Rs. 50 Lakhs. There has been reduction of Rs. 10 Lakhs at reporting date. How this needs to be dealt with?

Answer -The reduction of Rs. 10 lakhs needs to be recognised.

Issue – Unguaranteed residual value which was revised to Rs. 40 Lakhs, has witnessed an increase of Rs. 15 lakhs at next reporting date. How this needs to be dealt with?

Question:

Whether upward revision in residual value is to be totally ignored or can it be taken upto 50 lakhs? The original residual value in above example.

Answer - Upward revision needs to be restricted to 50 lakhs only i.e. at originally estimated unguaranteed residual value. Any excess above Rs. 50 lakhs needs to be ignored.

Initial direct cost borne by lessor – either charge off to P & L or allocate against finance income over a period of lease term.

Operating Lease –

- To be disclosed under PPE
- Income recognition – on straight lining basis or other systematic basis

Sale and Lease back Transactions

Lessee

Finance Lease -

- Excess or deficit deferred and amortised over a period of lease in proportion to depreciation

Operating Lease -

- If at fair value – excess or deficit to P & L
- If less than fair value – deficit to P & L unless lessee would be compensated by way of reduced future lease payments. In that case, deficit to be amortised over the period
- If above than fair value- excess to be deferred and amortised over the period

Disclosures - In case of Lessee

- Contingent rent recognised as an expense in the statement of P & L
- Future lease payments under non-cancellable operating leases for each of the following periods:

a) Not more than 1 year

b) Later than 1 year but not later than 5 years

c) Later than 5 years

Questions

1. How do we determine the dismantling cost as per AS -19.

2. Can we capitalise the borrowing cost on the leasehold improvement costs for a warehouse taken on lease and leasehold improvement done over it.

Answer:

1. PV of the estimated cost to be incurred. Discounting to be carried out considering the inflation rate and risk-free rate i.e. govt bond yield rate. The rate has to be pre-tax rate. Provision needs to be made in accordance with AS 29 and added to the cost of leased asset.

2. Yes, if leasehold improvements are qualifying asset as per AS-16.

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term or just for non-cancellable part?

Whether lease equalisation done on both cancellable and non-cancellable period?

Answer:

Lease term is the non-cancellable period only. Cancellable period is not included while determining lease term. Hence, straight lining or equalisation needs to be done for lease term i.e. non cancellable period.

Questions

Difference between Finance Lease & Operating Lease

Answer:

Classification:

a) Consideration of Substance and financial reality

b) Transfer of substantial risk and rewards incidental to ownership

c) Longer term

d) Risk of obsolescence, repair & maintenance cost

e) Full pay-out from single lease

- Recognition and Measurement
- Finance lease – asset and liability to be recognised at least equal to Fair value of the asset
- Operating lease – To be expensed off unless qualifies for capitalisation under other AS

Effect of lease equalisation in case of rent concession – whether the benefit will be apportioned in the period remaining from 01.04.2019 till termination, or will it be credited in respective months only?

Answer:

- Credit to P & L as & when entitlement falls due, if one-off occurrence, exceptional in response to Covid 19 (treated as variable lease payment under Ind AS 116)
- If not one-off occurrence, the entire lease period should be considered and cumulative effect of adjustment to be recognised in P & L or MLP, as the case may be.

Questions

Kesar Limited wishes to obtain a machine costing Rs. 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Pista Ltd., for a lease rental for Rs. 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. Advise the accountant of Kesar Limited about the accounting treatment of these lease rentals.

Answer:

- Operating lease since economic life is 14 years whereas useful life is 5 years
- Lease rentals to be charged to P & L
- Since it is not finance lease, implicit rate is not relevant

5 years lease with 2 years lock-in. Whether lease non-cancellable for first 2 years and thereafter cancellable? Also, for in future – should we need to show amount payable for first two years only (being non-cancellable period)?

Answer:

- Lease term covers non cancellable period
- Lock in or absence thereof would not determine the lease term
- Unless there exist, clauses related to cancellation as mentioned in AS, the entire contracted lease term would be construed as non cancellable, i.e. 5 years. Disclosures to be made for 5 years.

Questions

How to determine the dismantling cost in case of we taking any property on lease. The amt would be payable in future and hence problem is how to determine it now and account for it. (AS-19)?

Answer:

Measurement of dismantling cost needs to be made in accordance with AS 29 on best estimate basis based on entity specific facts and circumstances, industry practice etc. Discounting to be carried out considering the inflation rate and risk-free rate i.e. govt bond yield rate. The rate has to be pre-tax rate. Provision needs to be made in accordance with AS 29. In my view, the said provision is required to be added to the cost of leased asset, if it is finance lease and needs to be straight lined in case of operating lease.

AS-29 "Provisions, Contingent Liabilities and Contingent Assets"

Key Concepts

Onerous Contracts

Provision is a liability – substantial degree of estimation – Present obligation- outflow probable and reliably measurable

Liability – **present obligation** from past events where outflow of resources is expected

Issue – whether liability and provision are one & same?

Answer - No. Provisions involve substantial degree of estimation whereas liabilities involve substantial degree of accuracy.

Obligating event – is an event that creates an obligation – no realistic alternative but to settle the obligation. Past event that leads to present obligation is also obligating event

Contingent Liability

- Possible Obligation
- **Present obligation** but where probability of outflow of resources is remote or where reliable estimate of obligation could not be made

Issue – Tax demand contested at higher forum - Foreign vendors payment o/s for more than 3 years

Answer – Tax demand is present obligation. However, an entity may in its considered wisdom or through legal opinion envisage that the probability of outflow of resources is remote. Foreign vendor payment – compounding – penalty may or may not be imposed. – reliable estimate can not be made.

Single item leading to both, provision and contingent liability – corporate guarantee given for credit facilities availed by joint venture.

Measurement

- **Provisions**
- Best estimate basis
- Due consideration given to risk and uncertainties

Issue - Netting off of other expenditure against provision created for another purpose?

Answer – Netting off of other expenditure against provision created for another purpose is not allowed

Reimbursements

- Virtually certain
- Separate asset in balance sheet
- Net basis in P & L
- Joint and several liability Vs. solely responsible

Restoration Costs –

Issue: The company has carried out feasibility report which indicates that restoration of site would be required and cost to be incurred. As a result, the company was compelled to enter into Binding agreement with government to restore the site after mining extraction period is over. When to recognise provision?

Answer - Timing of obligating event is when entity commences mining extraction related activities.

Disclosures

- Provisions – expected timing of settlement
- Contingent liability

a) Estimate of financial effect

b) Indication of uncertainty relating to outflow

Contingent assets are neither recognised unless backed by virtual certainty of realisation nor disclosed

Questions

A Ltd. took a factory premises on lease on 1.4.2016 for Rs. 2,00,000 per month. The lease is operating lease. During March, 2017, A Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2019.The lease cannot be cancelled and cannot be sub-let to another user. The company seeks your advice whether the lease rent of balance 33 months upto 31.12.2019 should be provided in the accounts for the year ending 31.3.2017.

Answer:

Yes, this becomes onerous contract and lease agreement is binding one. These are unavoidable costs and provision needs to be made. The obligating event is when lease contract becomes binding.

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?

Answer:

Here, let us understand what is obligating event. It is contamination of land. why this is obligating event because it is virtually certain that law requiring cleaning up would be enacted. The outflow of resources is probable and hence provision is required to be made based on best estimate of cost that would be incurred.

Questions

When contingent liability needs to be disclosed with respect to letter of credit given for import purchases when:

a. No supplies are yet made at reporting date

b. Supplies are made at reporting date and as per inco terms risk and rewards are transferred to the company

c. Supplies are made at reporting date and as per inco terms no risk and rewards are transferred to the company

Answer:

- Two issues are critical:
- Timing of obligating event giving rise to obligation
- Recognition of primary transaction
- No need to disclose LC availed as contingent liability, however LC availed for third party would need to be disclosed as contingent liability.

The answer is relative and may change based on the nature of LC arrangement.

Questions?