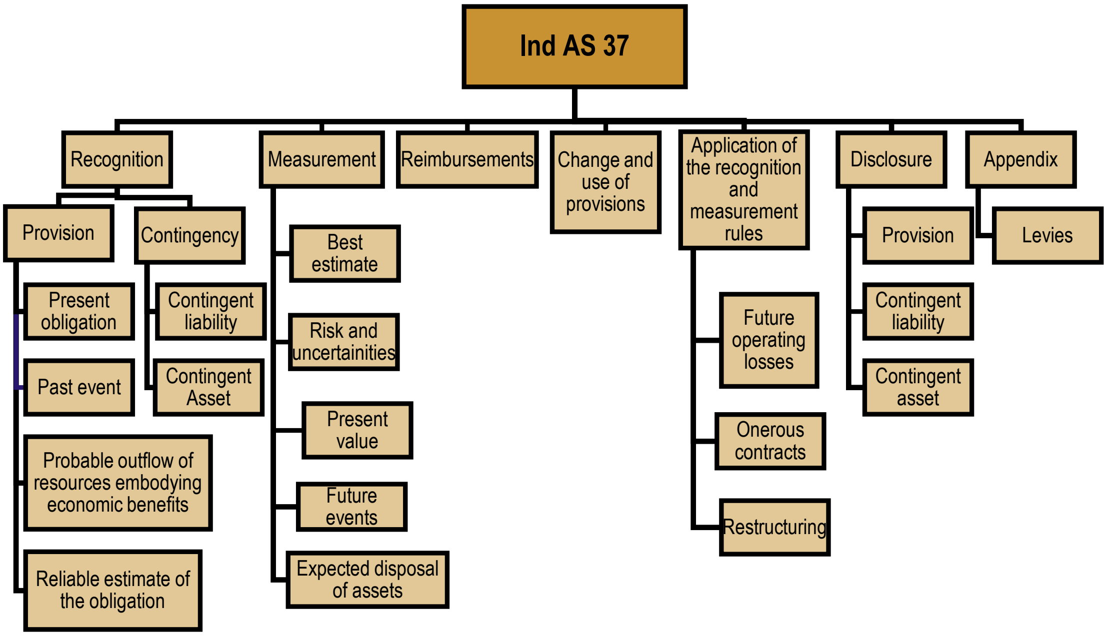
UNIT 2: INDIAN ACCOUNTING STANDARD 37: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define the terms like 'provision', 'contingent liability', 'contingent asset', obligating event, legal obligation, constructive obligation, onerous contracts and restructuring
- Appreciate the relationship between provision and contingent liability
- Recognise provision by examining present and past obligation, probability and estimate of the cash outflow.
- Apply the recognition principles of contingent assets and contingent liabilities
- Apply the recognition and measurement principles for future operating losses, Onerous contracts and restructuring
- Comply with the disclosure requirements with regard to disclosure of provisions, contingent liabilities and contingent assets as per Ind AS 37
- Differentiate between Ind AS 37 and AS 29

UNIT OVERVIEW



2.1 OBJECTIVE

The objective of Ind AS 37 is to ensure that

- appropriate recognition criteria and measurement bases are applied to
  - provisions
  - contingent liabilities and
  - contingent assets and
- sufficient information is disclosed in the notes to enable users to understand their
  - nature
  - timing and
  - amount.

2.2 SCOPE

Ind AS 37 should be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, **except:**

(a) those resulting from **executory contracts**, except where the contract is onerous; and

(b) financial instruments (including guarantees) that are within the scope of Ind AS 109, *Financial Instruments;*

(c) those covered by another Standard such as:

(i) revenue from contracts with customers covered by Ind AS 115. However, Ind AS 115 contains no specific requirement to address onerous contracts with customers. Hence, Ind AS 37 applies to such cases;

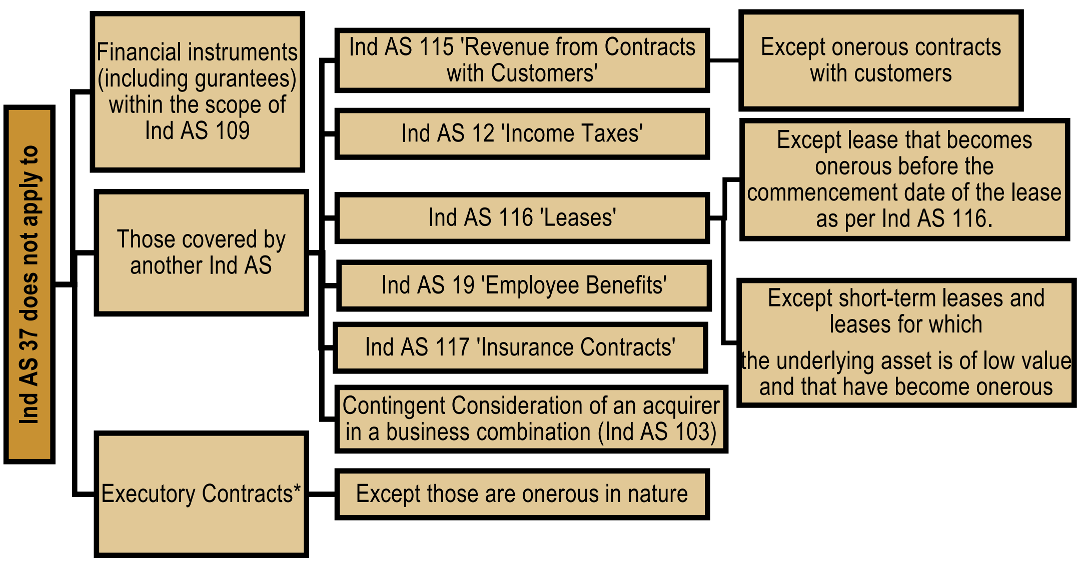
(ii) income taxes (Ind AS 12, *Income Taxes*);

(iii) leases (Ind AS 116, *Leases*). However, this Standard applies to any lease that becomes onerous before the commencement date of the lease as defined in Ind AS 116. This Standard also applies to short-term leases and leases for which the underlying asset is of low value accounted for in accordance with paragraph 6 of Ind AS 116 and that have become onerous;

(iv) employee benefits (Ind AS 19, *Employee Benefits*);

(v) ***insurance contracts and other contracts (within the scope of Ind AS 117, Insurance Contracts);*** and

(vi) Contingent consideration of an acquirer in a business combination (Ind AS 103, *Business Combinations*)



2.2.1 Executory Contracts

Executory contracts are contracts under which

- ❖ neither party has performed any of its obligations or
- ❖ both parties have partially performed their obligations to an equal extent.

For example:

- ❖ employee contracts in respect of continuing employment;
- ❖ contracts for future delivery of services such as gas and electricity;
- ❖ obligations to pay local authority charges etc are executory contracts.

Note: Ind AS 37 is applied to executory contracts only if they are onerous. For example, a long-term purchase contract that has a higher unit cost than unit sales price.

Example 1 : Where both parties have performed their obligations to an equal extent

On 1st April 20X2, Company XYZ Limited enters into a contract with Company PQR Limited for the manufacture and delivery of 200 units of component A at five different dates in the future, i.e. 1,000 units are to be delivered in total. Payment is due on delivery of the units.

On 1st April 20X2, the contract between Company XYZ Limited and Company PQR Limited is executory because neither party has performed any of its obligations; Company XYZ Limited has not manufactured or delivered any of the units, nor has Company PQR Limited paid for any of them.

By 1st June 20X2, Company XYZ Limited has produced and delivered 400 of the units and Company PQR Limited has paid in full for those 400 units. At this date, the contract between Company XYZ Limited and Company PQR Limited continues to be executory because both parties have partially performed their obligations to an equal extent.

By 1st September 20X2, Company XYZ Limited has produced and delivered the full 1000 units, but Company PQR Limited has only paid for 800 units in total. The contract between Company XYZ Limited and Company PQR Limited no longer meets the definition of an executory contract because the two parties have not performed under the terms of the contract to an equal extent. Company PQR Limited is required to recognise a liability for the final 200 units of component A for which it has not yet paid.

2.2.2 Provisions when relate to the recognition of revenue or expense/losses

- Some amounts treated as provisions may relate to the recognition of revenue.

  Example: Where an entity gives guarantees in exchange for a fee.

  Ind AS 37 does not address the recognition of revenue since there is a separate standard on it i.e. Ind AS 115, *Revenue from Contracts with Customers.* However, Ind AS 115 does not deal with onerous contracts with customers, so Ind AS 37 will deal with the same.

- As per Ind AS 37, provisions are liabilities of uncertain timing or amount. However, the term 'provision' is also used for certain adjustments which are made to the carrying amounts of assets.

  Example: Depreciation, impairment of assets and doubtful debts.

  The provisions which are adjustments to the carrying amounts of assets are not addressed in Ind AS 37 since other Ind AS specifies their treatment. Ind AS 37 neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

- Ind AS 37 applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations.*

2.3 DEFINITIONS

The following definitions are relevant for the purpose of understanding the requirements of Ind AS 37.

1. A ***provision*** is a liability of uncertain timing or amount.

2. A ***liability**** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

* The definition of a liability in this Standard is not revised following the revision of the definition of a liability in the *Conceptual Framework for Financial Reporting under Indian Accounting Standards* issued in 2021 by the Institute of Chartered Accountants of India.

3. An ***obligating event*** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Example 2

X Ltd. entered into a contract with Y Ltd. for supply of some material. As per the terms of contract in case of breach of contract, the party who breaches the contract has to pay ₹ 50,00,000 to other party. X Ltd. breached the contract with Y Ltd. Now in this case the obligating event is the breach of contract that gave rise to present obligation and X Ltd. must settle the obligation.

4. A ***legal obligation*** is an obligation that derives from:

   (a) a contract (through its explicit or implicit terms);

   (b) legislation; or

   (c) other operation of law.

Example

In the aforesaid example regarding breach of the contract, the obligation is a legal obligation that arises from the terms of contract.

5. A ***constructive obligation*** is an obligation that derives from an entity's actions where:

   (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

   (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Examples 3 - 5

3. X Ltd. is engaged in the manufacture of fertilisers. Effluents discharged in the manufacturing process have polluted the river near the manufacturing plant. The residents of the nearby locality launched a massive agitation against the pollution. X Ltd. agreed to their demands to reduce the water pollution by installing the necessary Effluent Treatment Plant. However, during the year no steps are taken to install the plant. No legislation requiring the company to reduce its pollution is in existence. In this case, though there is no law but by promising to take steps to reduce pollution, X Ltd. has created a valid expectation on the part of public that it

will discharge its responsibilities. So the obligation in this case is a constructive obligation.

4. An entity has prepared a formal plan for a re-organisation involving site closures and redundancies. The plan has been approved by the board at the year end, but the entity will not implement or announce the re-organisation until after the year end. There is no constructive obligation, even if there is an announcement after the entity's year end but before its financial statements are approved. The announcement is a non-adjusting post balance sheet event and there was no commitment to restructure at the year end. The entity could change its plans completely after the year end. A constructive obligation would exist if the entity has raised a valid expectation in those affected by beginning to implement the re-organisation by the end of the year (for example, by scrapping the plant or informing employees and suppliers of the re-organisation), despite the absence of a formal announcement.

5. A retail store has a generally known policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. In these circumstances, the sale of its products gives rise to a constructive obligation because the entity (through its reputation for providing refunds) has created a valid expectation on the part of customers that a refund will be given if they are dissatisfied with their purchase.

6. A **contingent liability** is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

Example 6

A tax case pending before the court, the liability for payment arising or not in respect of which depends on the outcome of court decision is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

7. A ***contingent asset*** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Example 7

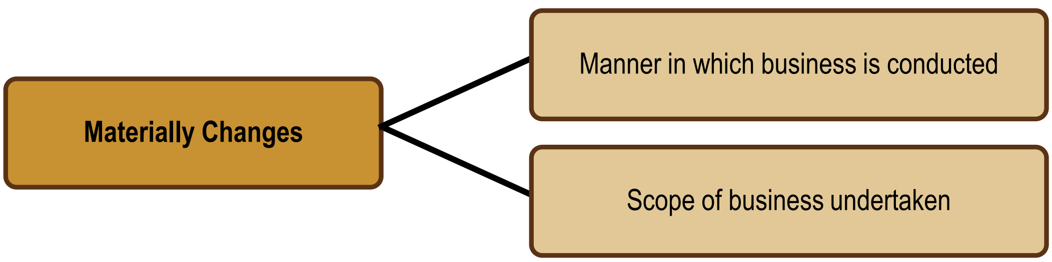
X Ltd. filed a legal suit against a supplier of goods for compensation against damages on non–supply of contracted goods. This meets the definition of a contingent asset since there is a possible asset (compensation against damages) that arose from past event (contract with the supplier) and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future event not wholly within the control of the entity (i.e., the outcome of the legal suit).

8. An ***onerous contract*** 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.

9. 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 entity; or

   (b) the manner in which that business is conducted.



2.4 PROVISIONS AND OTHER LIABILITIES

Since there is uncertainty about the timing or amount of the future expenditure required in settlement of the provisions, they are different from liabilities. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees.

Example: Amounts relating to accrued vacation pay.

Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Note: Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

Examples on provisions and other liabilities:

Nature of obligation	Recognition as provision as per Ind AS 37 (Yes/No)	Reasons
Amount payable for utilities like electricity, gas, etc.	No	Amount payable for utilities represents an accrual of liability to pay for services that have been received. The amount and timing of payment can be determined with a reasonable certainty. The timing for payment is known since the utility companies have fixed dates every month/period for the purpose of settlement of dues. A reliable estimate of the amount of payment can be made based on the quantum of consumption, prevailing rates or on the basis of earlier bills.
Goods or services received, but not invoiced	No	Amount payable for supply of goods and services received under a formally agreed contract represents trade payables even if invoice has not been received. In such a case, amount and timing of payment would be driven by the terms agreed with the supplier.
Financial guarantee given by the parent to lenders for loan taken by its subsidiary	No	Financial guarantees are within the scope of Ind AS 109 *Financial Instruments*

Warranty obligations	Yes	Warranty obligation represents the additional cost that the seller may have to incur to rectify product defects. This is in the nature of provision as there is an uncertainty associated with the amount and timing of the liability.

2.5 RELATIONSHIP BETWEEN PROVISIONS AND CONTINGENT LIABILITIES

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, Ind AS 37 distinguishes between the term 'contingent' and 'provisions'.

(a) **Provisions –** which **are recognised as liabilities** (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

Provision = Present obligation from past event + Outflow is probable + Ability to measure

(b) **Contingent Liabilities –** which **are not recognised as liabilities** because they are either:

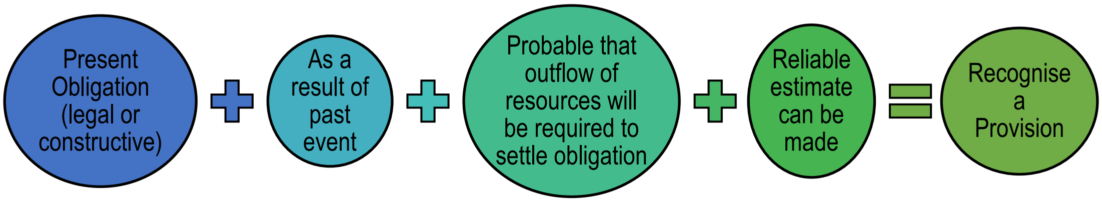
(i) **possible obligations**, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

(ii) **present obligations** that do not meet the recognition criteria in Ind AS 37 (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

Contingent Liability = Possible obligation from past event and /or Outflow is not probable and /or Unable to measure

2.6 RECOGNITION

2.6.1 Provisions



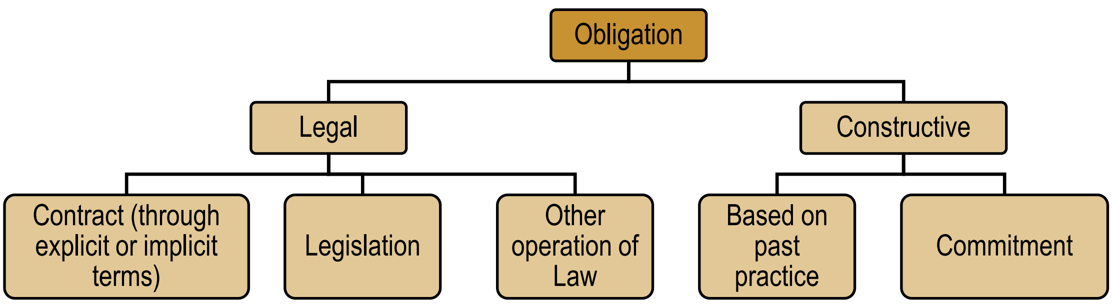
A provision should be recognised when:

(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 should be recognised.



2.6.1.1 Present Obligation

- ❖ In general, it is clear that there is a present obligation. Only, in rare cases it is not clear whether there is a present obligation.
- ❖ In almost all cases it will be clear whether a past event has given rise to a present obligation.

Illustration 1

ABC Limited is an automobile component manufacturer. The automobile manufacturer has specified a delivery schedule, non-adherence to which will entail a penalty. As on 31st March, 20X1, the reporting date, the manufacturer has a delivery scheduled for

June 20X2. However, the manufacturer is aware that he will not be able to meet the delivery schedule in June 20X2.

Determine whether the entity has a present obligation as at 31st March, 20X1, requiring recognition of provision.

Solution

In this case, there is no present obligation arising out of a past event as the goods are scheduled for delivery in June 20X2 and there is no delay as at 31st March, 20X1. Hence, there is no present obligation to pay the penalty in the current year. Therefore, there is no present obligation to recognise the provision.

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- Where it is not clear whether there is a present obligation, past event shall be evaluated.
- In such a case, an entity should take into account all available evidence, including the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period.
- On the basis of such evidence:

  (a) where it is probable (i.e. more likely than not) that a present obligation exists at the end of the reporting period,

  - the entity **recognises a provision** (if the recognition criteria are met); and

  (b) where it is **more likely that no present obligation exists** at the end of the reporting period,

  - the entity discloses a contingent liability, if the possibility of an outflow of resources embodying economic benefits is not remote.

Note: It may be inferred that if the possibility of an outflow of resources embodying economic benefits is remote, then the entity need not disclose the contingent liability.

2.6.1.2 Past Event

- A past event that leads to a present obligation is called an obligating event. Obligating event, is the event where the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

  (a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

❖ There should be a past event which lead to present obligation and give rise to a liability for which a provision is required to be made.

Example 8

1. In respect of contamination of land, it would be the original contamination.

2. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

❖ No provision is recognised for costs that need to be incurred by an entity to operate in the future.

❖ The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.

❖ It is only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) that should be recognised as provisions.

Examples 9 & 10

9. Penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.

10. Similarly, an entity should recognise a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused.

❖ In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future.

❖ The entity can avoid the future expenditure by its future actions (for example by changing its method of operation). In such a case, it has no present obligation for that future expenditure and no provision is recognised.

Example 11 : Fitting smoke filters in a certain type of factory.

Since, the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

Example 12 : Staff retraining as a result of changes in the income tax system

The government introduces a number of changes to the income tax system. As a result of these changes, an entity 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 end of the reporting period, no retraining of staff has taken place. It is assumed that a reliable estimate can be made of any outflows expected.

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.

Example 13: Legal requirement to fit smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by 30th September, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31st March, 20X1, the end of the reporting period

Present obligation as a result of a 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.

(b) At 31st March, 20X2, the end of the reporting period

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.

Example 14: Repairs and maintenance

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. Ind AS 16, *Property, Plant and Equipment* gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

Example 15: Refurbishment costs – no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

Conclusion – No provision is recognised.

The cost of replacing the lining is not recognised because, at the end of the reporting period, 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. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e., it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Example 16: Refurbishment costs – legislative requirement

An airline is required by law to overhaul its aircraft once every three years. It is assumed that a reliable estimate can be made of any outflows expected.

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 example on refurbishment costs. 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 entity's future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e., an amount equivalent to the expected maintenance costs is depreciated over three years.

Illustration 2

X Shipping Ltd. is required by law to overhaul its shipping fleet once in every 3 years. The company's finance team was of the view that recognising the costs only when paid would prevent matching of revenue earned all the time with certain costs of large amounts which are incurred occasional. Thereby, it has formulated an accounting policy of providing in its books of account for the future cost of maintenance (overhauls, annual inspection etc.) by calculating a rate per hours sailed on sea and accumulating a provision over time. The provision is adjusted when the expenditure is actually incurred.

Comment whether the accounting policy of X Shipping Ltd. is correct.

Solution

A provision is made for a present obligation arising out of a past event. Even a legal requirement to overhaul does not make the cost of overhaul a liability, because no obligation exists to overhaul the ships independently of the company's future actions - the company could avoid the future expenditure by its future actions for example by selling the ships. So there is no present obligation.

As per the standard, financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.

Therefore, the accounting policy of X Shipping Ltd. is not correct. The company should adopt the component approach in Ind AS 16, *Property, Plant and Equipment*, for accounting for the refurbishment cost.

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- ❖ An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed.

- A management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.
- An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation.

Example 17

An entity may not be obliged to remedy the consequences due to causing of environmental damage by it. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

- Where details of a proposed new law have yet to be finalised, an obligation would arise only when the legislation is virtually certain to be enacted as drafted. For the purpose of Ind AS 37, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Example 18: Contaminated land – legislation virtually certain to be enacted

An entity in the oil industry (having 31^{st} March year-end) causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At 31^{st} March, 20X1, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement – Probable.

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

Example 19: Contaminated land and constructive obligation

An entity in the oil industry (having 31st March year-end) causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement- Probable.

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

Example 20: Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual 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 end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, 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 – Probable.

Conclusion – A provision is recognised 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. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Example 21: A Court case

After a wedding in 20X1-20X2, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of approval of the financial statements for the year to 31st March 20X2 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31st March 20X3, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31st March 20X2

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 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 31st March 20X3

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.

Illustration 3

X Chemical Ltd. is operating in the vicinity of a river since 20 years. A community living near X Chemical Ltd. claims that its operations has caused contamination of drinking water. X Chemical Ltd. has received notice from the governmental environmental agency that official investigations will be made into claims of pollution caused by the entity. If it is found that X Chemical Ltd. has caused contamination, then penalties and fine would be levied on it.

X Chemical Ltd. believes that it has implemented all environmental safety measures to an extent that it is unlikely to cause pollution. Management is not sure whether it has all the information about the entire 20 years. Therefore, neither management nor external experts are able to assess X Chemical Ltd.'s responsibility until the investigation has completed.

In such situation, how should management of X Chemical Ltd. account for a liability?

Solution

As per the standard, in the present case, the available evidence does not support a conclusion that a present obligation exists. However, there is a possible obligation which exists and will be confirmed upon completion of investigations. Therefore, management should disclose the contingent liability for potential penalties and fines that may be imposed if contamination is proved.

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2.6.1.3 Probable Outflow of Resources Embodying Economic Benefits

- 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.

> **Note:** For the purpose of Ind AS 37[1], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

- Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

- Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision should be recognised (if the other recognition criteria are met).

Example 22: 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. It is assumed that a reliable estimate can be made of any outflows expected.

[1] The interpretation of 'probable' in Ind AS 37 as 'more likely than not' does not necessarily apply in other Ind AS.

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 a legal 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 end of the reporting period.

2.6.1.4 Reliable Estimate of the Obligation

- The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the balance sheet.
- Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

Illustration 4

X Ltd. has entered into an agreement with its selling agent Y, in accordance with which X Ltd. has to pay a base percentage of commission on export sales and an additional commission is to be paid if the export incentives are received. As per the accounting policy of X Ltd., it recognises export incentives when actually realised, on account of the uncertainty in realising such incentives. Export incentives have not been received for the year 20X1-20X2, however X Ltd. is hopeful of receiving the export incentives in the year 20X2-20X3.

State whether in the financial statements for 20X1-20X2, should X Ltd. provide for both base commission and additional commission.

Solution

So far as the base percentage of sales commission is concerned, it is a present obligation arising out of past events. The obligating event takes place when the sales are made and also since commission is based on percentage of sale, reliable estimation can also be made. Therefore, the base percentage of sales commission should be provided.

However, in respect of additional commission, it is to be paid when the export incentives are recognised and export incentives are recognised only when it is received. Therefore, the obligating event will arise only when export incentives are received. Hence, no provision for additional commission is to be made in financial year 20X1-20X2. The expectation of X Ltd. to receive the export incentives in next year would not make any difference as on 31st March 20X2.

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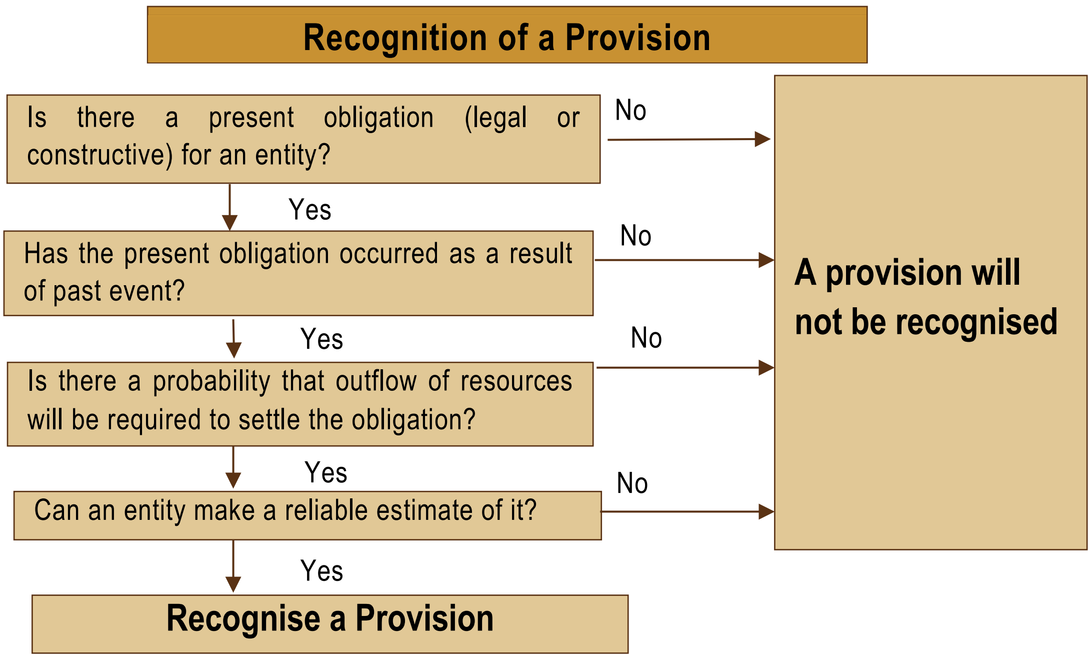
- In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.



2.6.2 Contingent Liabilities

- An entity should not recognise a contingent liability.
- A contingent liability should be disclosed, if the possibility of an outflow of resources embodying economic benefits is not remote.
- Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties should be treated as a contingent liability.
- The entity should recognise a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

- Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.
- If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision should be recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

The principles describing provisions and contingent liabilities is as follows:

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.		
There is a present obligation that probably requires an outflow of resources.	**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.

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability.

2.6.3 Contingent Assets

- An entity should not recognise a contingent asset.
- Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

Example

A claim that an entity is pursuing through legal processes, where the outcome is uncertain.

- Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised.
- However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- A contingent asset should be disclosed, where an inflow of economic benefits is probable.
- Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements **of the period in which the change occurs.**

Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity		
The inflow of economic benefits is virtually certain	**The inflow of economic benefits is probable, but not virtually certain**	**The inflow is not probable**
The asset is not contingent and its recognition is appropriate	No asset is recognised	No asset is recognised
	Disclosures are required	No disclosure is required

Tabular depiction

Likelihood of outcome	Contingent liability	Contingent asset
Virtually certain (greater than 95% probability)	Recognise the provision	Recognise the asset
Probable (50% - 95% of probability)	Recognise the provision	Disclose about the contingent asset
Possible but not probable (5% - 50% of probability)	Disclose the contingency	No disclosure permitted
Remote (less than 5% probability)	No disclosure required	No disclosure permitted

2.7 MEASUREMENT

- Best Estimate
- Risk and Uncertainity
- Present Value
- Future Events
- Expected Disposal of Assets

2.7.1 Best Estimate

❖ The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

❖ The estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

❖ The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and in some cases, reports from independent experts, for example, in legal cases, expert legal advice might be taken. The evidence considered includes any additional evidence provided by events after the reporting period.

❖ Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, for example, customer refunds, warranties, etc., the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60% or 90%.

❖ Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

Illustration 5

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of ₹ 1 million would result. If major defects were detected in all products sold, repair costs of ₹ 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects.

Assess the probability of an outflow for the warranty obligations as a whole.

Solution

The expected value of the cost of repairs is:

(75% of nil) + (20% of 1m) + (5% of 4m) = ₹ 4,00,000

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- ❖ Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes.

Example 23

An entity faces a single legal claim, with a 40 per cent likelihood of success with no cost and a 60 percent likelihood of failure with a cost of ₹ 1 million. Expected value is not valid in this case because the outcome will never be a cost of ₹ 600,000 (60 percent × ₹ 1 million); the outcome will either be nil or ₹ 1 million. Ind AS 37 indicates that the provision may be estimated at the individual most likely outcome. In this example, it is more likely that a cost of ₹ 1 million will result and, therefore, a provision for ₹ 1 million should be recognised.

- ❖ Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

Examples 24 & 25

24. If an entity has an environmental obligation to clean up the drinking water that got contaminated, there might be a number of different ways to carry out this work. Each of these methods would have different probabilities of success and would cost different amounts. In such case, the entity might choose the method which has the most likely possibility of success.

25. If an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of ₹ 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

- Generally, when the most likely outcome is close to the expected value, it will be appropriate to provide for the most likely outcome because expected value provides evidence of the probable outflow of benefits.

Example 26

An entity is required to replace a major component of an asset under warranty. Each time replacement costs ₹ 1 million. From experience, there is a 30 per cent chance of a single failure, a 50 per cent chance of two failures, and a 20 per cent chance of three failures.

The most likely outcome is two failures, costing ₹ 2 million. The expected value is ₹ 1.9 million [(30 per cent x ₹ 1 million) + (50 per cent x ₹ 2 million) + (20 per cent x ₹ 3 million)]. The expected value supports the provision for the most likely outcome of ₹ 2 million.

- The provision should be measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under Ind AS 12.

2.7.2 Risks and Uncertainties

- The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.
- Risk describes variability of outcome.
- A risk adjustment should be made for the amount that the entity would pay in excess of the expected present value of outflows due to uncertainty attached with the actual outcome.
- A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities.

  For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case.

- Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.
- Risk adjustment can be accounted for in number of ways such as:
  - Adding it to the expected present value of future outflows.
  - Adjusting the estimates of future outflows.
  - Adjusting the discount rate.
- Disclosure of the uncertainties surrounding the amount of the expenditure should be made.

2.7.3 Present Value

- 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.
- Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions should therefore be discounted, where the effect is material.
- Ind AS 37 does not require cash flows to be discounted unless this has a material effect.
- The expected present value of outflows are calculated as follows:
  - Each outcome is discounted to its present value.
  - The present value of outcomes are weighted by their associated probabilities.
- **The discount rate (or rates) should be a pre-tax rate (or rates)** that reflect(s) current market assessments of the time value of money and the risks specific to the liability.
- The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Illustration 6

X Solar Power Ltd., a power company, has a present obligation to dismantle its plant after 35 years of useful life. X Solar Power Ltd. cannot cancel this obligation or transfer to third party. X Solar Power Ltd. has estimated the total cost of dismantling at ₹ 50,00,000, the present value of which is ₹ 30,00,000. Based on the facts and circumstances, X Solar Power Ltd. considers the risk factor of 5% i.e., the risk that the actual outflows would be more from the expected present value.

State how should X Solar Power Ltd. account for the obligation.

Solution

The obligation should be measured at the present value of outflows i.e., ₹ 30,00,000. Further a risk adjustment of 5% i.e., ₹ 1,50,000 (₹ 30,00,000 x 5%) would be made.

So, the liability will be recognised at = ₹ 30,00,000 + ₹1,50,000 = ₹ 31,50,000.

Illustration 7

ABC Ltd. has an obligation to restore the seabed for the damage it has caused in the past. It has to pay ₹ 10,00,000 cash on 31st March 20X3 relating to this liability. ABC Ltd.'s management considers that 5% is an appropriate discount rate.

Calculate the amount to be provided for at 31st March 20X1 for the costs of restoring the seabed and its accounting at the year end 31.3.20X2 and 31.3.20X3.

Solution

Discounting factor of 5% for 2nd year as on 31st March 20X1 = $(1/1.05)^2$ = 0.907

The present value of the provision as on 31st March 20X1 is = ₹ 10,00,000 x 0.907

= ₹ 9,07,000

The amount of increase in the provision resulting from unwinding of discounting to reflect the passage of time should be included as an element of borrowing cost in determining the profit or loss for the year.

The provision should be initially recognised at ₹ 9,07,000 which is the present value of ₹ 10,00,000 discounted at 5% for two years. At the end of year 1 i.e. 31st March 20X2, the provision increases to ₹ 9,52,350, and the difference of ₹ 45,350 is recognised as borrowing cost. Similarly, for the year ending 31st March 20X3, the provision will increase to 10,00,000 and the increase being recognised as borrowing cost. Consequently, at the end of year 2 the amount of provision will be equal to the amount due, i.e., ₹ 10,00,000.

Note: There may be some difference in amount due to approximation (limiting discounting factor to 3 place decimal), which can be overcome either by full scale calculation or adjustment at the end.

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2.7.4 Future Events

❖ Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

- Expected future events may be particularly important in measuring provisions.

  For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology.

  The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence. It is fine to anticipate the use of existing method with the some refinement, adaptation and cost reduction, if there is sufficient evidence that such factors are likely to arise in future. However, it would not be acceptable to assume that there would be a completely new idea or a new method, which would be significantly cost effective.

- The effect of possible new legislation should be taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Illustration 8

X Chemicals Ltd. engaged in the chemical industry causes environmental damage by dumping waste in the river near its factory. It does not clean up because there is no environmental legislation requiring cleaning up and X Chemicals Ltd. is causing damage for last 40 years. As at 31st March, 20X2, the State Legislature has passed a path breaking legislation requiring all polluting factories to clean-up the river water already contaminated. The formal Gazette notification of the law is pending.

Comment on how should X Chemicals Ltd. deal with this situation.

Solution

The obligating event is the contamination of water and because of the virtually certainty of legislation requiring cleaning up, an outflow of resources is certain. It is possible to arrive at best estimated cost for the cleanup activity. So, a provision should be recognised in the books of X Chemicals Ltd. for 20X1-20X2.

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2.7.5 Expected Disposal of Assets

- ❖ Gains on the expected disposal of assets should not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.
- ❖ Instead, an entity should recognise gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned.

Example 27

At the end of 20X1, an entity is demonstrably committed to the closure of some facilities, having drawn up a detailed plan and made appropriate announcements. The expected impact of the plan is as follows:

	20X2	**20X3**
Committed closure costs	₹ 10,00,000	
Gain from sale of property		₹ 2,00,000

The provision required at the end of 20X1 is ₹ 10,00,000 (ignoring discounting). The expected gain on the sale of the property is dealt with separately under the derecognition criteria in Ind AS 16.

2.8 REIMBURSEMENTS

- ❖ 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 entity 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.
- ❖ In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.
- ❖ Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly.

- In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision should be recognised for the full amount of the liability, and a separate asset for the expected reimbursement should be recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.
- In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they should not be included in the provision.
- As noted earlier, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

In various situations where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the treatment would be as follows:

Reimbursements			
Situation	**The entity has no obligation for the part of the expenditure to be reimbursed by the other party**	**Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party and it is virtually certain that reimbursement will be received if the entity settles the provision**	**Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party but the reimbursement is <u>NOT</u> virtually certain**
Recognition	The entity has no liability for the amount to be reimbursed. Hence no provision will be made.	• The reimbursement is recognised as a separate asset in the balance sheet • In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement. • The amount recognised for the expected	The expected reimbursement is not recognised as an asset.

		reimbursement shall not exceed the liability.	
Disclosure	No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement.	The expected reimbursement is disclosed.

Illustration 9

X Beauty Solutions Ltd. is selling cosmetic products under its brand name 'B', but it is getting its product manufactured from Y Ltd. It has an understanding (enforceable agreement) with Y Ltd. that if the company becomes liable for any damage claims, due to any injury or harm to the customer of the cosmetic products, 30% will be reimbursed to it by Y Ltd. During the financial year 20X1-20X2, an estimate of the claim of ₹ 30,00,000 may be payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?

Solution

Since the understanding results in an enforceable agreement, the reimbursement of ₹ 9,00,000 (₹ 30,00,000 x 30%) shall be recognised as a reimbursement right and provision will be recognised for ₹ 30,00,000. The reimbursement right shall be treated as a separate asset and shall not be offset with the provision. In the statement of profit and loss, the expense may be presented as ₹ 21,00,000 after offsetting the reimbursement right.

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2.9 CHANGES IN PROVISIONS

❖ Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

❖ Once the amount of the obligation is crystallised and there is no uncertainty associated with an obligation, the liability is no longer a provision. The same should be reclassified as an element within liabilities.

Example 28

Customer X has made a claim of ₹ 2 million for liquidated damages, the entity is disputing the amount of claim. Due to the uncertainty involved in the amount payable, the entity recognises this as a provision. After negotiation with the customer, the amount is agreed at ₹ 1.5 million. As there is no uncertainty involved relating to the amount payable, it no longer meets the definition of provision and should be reclassified to an appropriate category within liabilities.

❖ Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Illustration 10

X Telecom Ltd. has income tax litigation pending before appellate authorities. Legal advisor's opinion is that X Telecom Ltd. will lose the case and estimated that liability of ₹ 1,00,00,000 may arise in two years. The liability is recognised on a discounted basis. The discount rate at which the liability has been discounted is 10% and it is assumed that discount rate does not change over the period of 2 years.

How should X Telecom Ltd. calculate the amount of finance cost?

Solution

The discount factor of 10% for 2 years is 0.826. X Telecom Ltd. will initially recognise provision for ₹ 82,60,000 (₹ 1,00,00,000 x 0.826).

The discount factor of 10% at the end of year 1 is 0.909. At the end of year 1, provision amount would be ₹ 90,90,000 (₹ 1,00,00,000 x 0.909).

As per the standard, the difference between the two present values i.e., ₹ 8,30,000 (90,90,000-82,60,000) is recognised as a finance cost in year 1.

At the end of the Year 2, the liability would be ₹ 1,00,00,000.

The difference between the two present values i.e., ₹ 9,10,000 (₹ 1,00,00,000 - ₹ 90,90,000) is recognised as finance cost in year 2.

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2.10 USE OF PROVISIONS

❖ A provision should be used only for expenditures for which the provision was originally recognised. Repurposing of the provisions is not allowed.

❖ Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

2.11 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

2.11.1 Future Operating Losses

- Provisions should not be recognised for future operating losses.
- Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions as specified in the standard. Ind AS 37 does not permit recognition of provision for future operating losses this since they do not stem from a past event.
- An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity should test these assets for impairment under Ind AS 36, *Impairment of Assets.*

Illustration 11

X Packaging Ltd. has two segments, packaging division and paper division. In March 20X1, the board of directors approved and announced a formal plan to sell the paper division in June 20X1. Operating losses of the paper division are estimated to be approximately ₹ 50,00,000 during the period from 1st April, 20X1 to the expected date of disposal. Management of X Packaging Ltd. wants to include the future operating loss of ₹ 50,00,000 in a provision for restructuring in the financial statements for the period ended 31st March, 20X1.

Recommend whether X Packaging Ltd. can include these operating losses in a provision for restructuring.

Solution

Standard states that provision should not be made for future operating losses. Since Ind AS 37 prohibits the recognition of future operating losses, so X Packaging Ltd. should not include these future operating losses in a provision for restructuring even though these losses relate to the disposal group.

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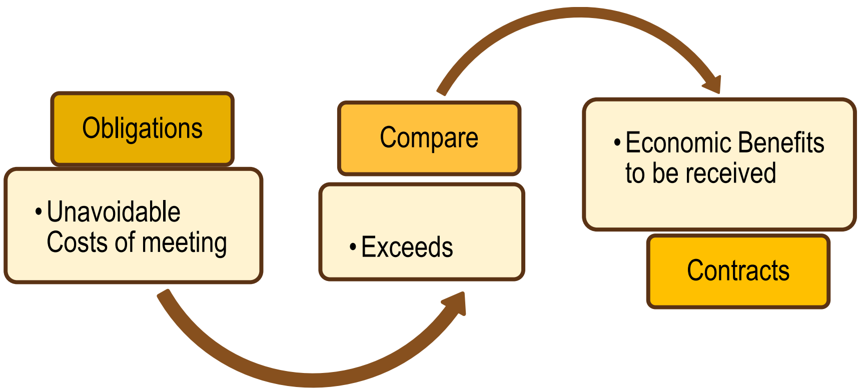
2.11.2 Onerous contracts

❖ If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision.



❖ Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of Ind AS 37 and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of Ind AS 37.

❖ Ind AS 37 defines an onerous contract as 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.

Note: Both the incremental costs to fulfil a contract and allocation of directly attributable costs will form part of the cost used for determination of onerous contract.

❖ Before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets used in fulfilling that contract (in accordance with Ind AS 36).

Examples 29- 32

29. **Contract not onerous:** An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. The gas will be

used to generate electricity, which will be sold at a profit. The economic benefits from the contract include the benefits to the entity of using the gas in its business and, because the electricity will be sold at a profit, the contract is not onerous.

30. **Impairment of assets:** The contract's terms and market prices are the same as in example 29. However, the electricity is sold at a loss, and the entity makes an overall operating loss. All of the gas purchased by the entity is used to generate electricity using dedicated assets. The electricity is sold to a wide range of customers. The entity first considers whether the assets used to generate electricity are impaired. To the extent that there is still a loss after the assets have been written down, a provision for an onerous contract should be recorded.

31. **Sale to third party at below purchase price:** The contract terms and market price are the same as in example 29. However, in this example, the entity sells the gas under contract, which it no longer needs, to a third party for 18p per unit (5p below cost). The entity determines that it would have to pay ₹ 55,000 to exit the purchase contract. The only economic benefit from the purchase contract costing ₹ 2,30,000 are the proceeds from the sales contract, which are ₹ 1,80,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of the cost of fulfilling the contract and the penalty cost of cancellation (₹ 55,000).

32. **Contract termination costs:** In the year ended 31st December 20X1, an entity has a contract with a third party supplier. The entity wishes to terminate this contract in 20X2 because it can enter into a cheaper contract with a new supplier, even though it will still have two years to run. It will incur a charge for terminating the contract. Does the entity have to provide in 20X1-20X2 for the contract that it will be exiting in 20X2-20X3? A provision should be recognised only if the contract is onerous. If the goods received under the supply contract are sold at a profit, the contract is not onerous and provision should not be made in 20X1-20X2. The termination cost should be recognised as incurred in 20X2-20X3.

Illustration 12

X Metals Ltd. had entered into a non-cancellable contract with Y Ltd. to purchase 10,000 units of raw material at ₹ 50 per unit at a contract price of ₹ 5,00,000. As per the terms of contract, X Metals Ltd. would have to pay ₹ 60,000 to exit the said contract. X Metals Ltd. has discontinued manufacturing the product that would use the said raw material. For that X Metals Ltd. has identified a third party to whom it can sell the said raw material at ₹ 45 per unit.

State how should X Metals Ltd. account for this transaction in its books of account in respect of the above contract?

Solution

These circumstances do indicate an onerous contract. The only benefit to be derived from the purchase contract costing ₹ 5,00,000 are the proceeds from the sale contact, which are ₹ 4,50,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of cost of fulfilling the contract and the penal cost of cancellation of ₹ 60,000.

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2.11.3 Restructuring

❖ The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

❖ A provision for restructuring costs should be recognised only when the general recognition criteria for provisions set out the standard are met.

❖ A constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least:

(i) the business or part of a business concerned;

(ii) the principal locations affected;

(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

(iv) the expenditures that will be undertaken; and

(v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Example 33: Closure of a division – no implementation before end of the reporting period

On 12th March, 20X1 the board of an entity decided to close down a division. Before the end of the reporting period (31st March, 20X1) the decision was not communicated to any of those affected and no other steps were taken to implement the decision. it is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There has been no obligating event and so there is no obligation.

Conclusion – No provision is recognised.

Example 34: Closure of a division – communication/ implementation before end of the reporting period

On 12th March, 20X1 (reporting date), the board of an entity decided to close down a division making a particular product. On 20th March, 20X1 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised at 31st March, 20X1 for the best estimate of the costs of closing the division.

- Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (i.e., setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

- For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

❖ A management or board decision to restructure taken before the end of the reporting period does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period:

(a) started to implement the restructuring plan; or

(b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting period, disclosure is required under, Ind AS 10, Events after the Reporting Period, if the restructuring is material and non-disclosure could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

❖ Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of the standard are met.

❖ In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (e.g., employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.

❖ No obligation arises for the sale of an operation until the entity is committed to the sale, i.e., there is a binding sale agreement.

❖ Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Ind AS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

❖ 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 entity.

❖ 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.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures should be recognised on the same basis as if they arose independently of a restructuring.

❖ Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract.

❖ Gains on the expected disposal of assets should not be taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Includes only the direct expenditures arising from the restructuring that are both:

(i) Necessarily entailed by restructuring

(ii) Not associated by the ongoing activities of the entity

Does not include such cost:

1. Retraining or Relocating continiung staff
2. Marketing or
3. Investment in new systems and distribution networks

Illustration 13

X Cements Ltd. has three manufacturing units situated in three different states of India. The board of directors of X Cements Ltd., in their meeting held on 10th January, 20X1, decided to close down its operations in one particular state on account of environmental reasons. A detailed formal plan for shutting down the above unit was also formalised and agreed by the board of directors in that meeting, which specifies the approximate number of employees who will be compensated and expenditure expected to be incurred. Date of implementation of plan has also been mentioned. Meetings were also held with customers, suppliers, and workers to communicate the features of the formal plan to close down the operations in the said state, and representatives of all interested parties were present in those meetings.

Evaluate whether the actions of the board of directors create a constructive obligation that needs a provision for restructuring.

Solution

As per Ind AS 37, the conditions prescribed are:

(a) there should be detailed formal plan of restructuring;

(b) which should have raised valid expectations in the minds of those affected that the entity would carry out the restructuring by announcing the main features of its plans to restructure.

The board of directors did discuss and formalise a formal plan of winding up the operation in the above said state. This plan was communicated to the parties affected and created a valid expectation in their minds that X Cements Ltd. would go ahead with its plans to close down operations in that state. Thus, there is a constructive obligation that needs to be provided at year-end.

*****

2.12 DISCLOSURE

❖ For each class of provision, an entity should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e., incurred and charged against the provision) during the period;

(d) unused amounts reversed during the period; and

(e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required to be disclosed.

- ❖ An entity should disclose the following for each class of provision:

  (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

  (b) an indication of the uncertainties about the amount or timing of those outflows.

  Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events; and

  (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

- ❖ Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

  (a) an estimate of its financial effect, measured in the standard;

  (b) an indication of the uncertainties relating to the amount or timing of any outflow; and

  (c) the possibility of any reimbursement.

- ❖ In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of the standard and

- ❖ Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

- ❖ Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by the standard in a way that shows the link between the provision and the contingent liability.

- ❖ Where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in the standard.

- It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.
- Where any of the information required by the standard is not disclosed because it is not practicable to do so, that fact should be stated.
- In extremely rare cases, disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Illustration 14 : Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the end of the reporting period, a provision of ₹ 60,000 has been recognised for the sale made during the year. The provision has not been discounted as the effect of discounting is not material.

Draft the Note.

Solution

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the current financial year. It is assumed that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years from the reporting period.

*****

2.13 LEVIES (APPENDIX C OF IND AS 37)

2.13.1 Appendix C deals with

- the accounting for a liability to pay a levy if that liability is within the scope of Ind AS 37
- accounting for a liability to pay a levy whose timing and amount is certain.

2.13.2 Appendix C does not deal with

- the accounting for the costs that arise from recognising a liability to pay a levy.

Note: Entities should apply other Standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense.

2.13.3 What is a Levy?

A charge imposed by governments on entities in accordance with laws and/or regulations. It leads to outflow of resources embodying economic benefits

It excludes

- outflows of resources that are within the scope of other Ind AS
- fines or other penalties that are imposed for breaches of the legislation
- payment made to the government for acquiring assets or for rendering services as per the contractual agreement
- liabilities that arise from emissions trading schemes.

Note: Government' refers to government, government agencies and similar bodies whether local, national or international.

2.13.4 Accounting Principles

- If and activity triggers the payment of the levy, it will be considered as an obligating event that gives rise to a liability to pay a levy

  Example 35

  If the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to create a present obligation.

- Any compulsion to operate in future will not be considered as constructive obligation for an entity, to pay a levy.

- The preparation of financial statements under the going concern assumption does not imply that an entity has a present obligation to pay a levy that will be triggered by operating in a future period.
- The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (ie if the activity that triggers the payment of the levy, as identified by the legislation, occurs over a period of time).

Example

If the obligating event is the generation of revenue over a period of time, the corresponding liability is recognised as the entity generates that revenue.

- If an obligation to pay a levy is triggered when a minimum threshold is reached, the accounting for the liability that arises from that obligation shall be consistent with the principles established in the standard.

Example

If the obligating event is the reaching of a minimum activity threshold (such as a minimum amount of revenue or sales generated or outputs produced), the corresponding liability is recognised when that minimum activity threshold is reached.

- An entity shall apply the same recognition principles in the interim financial report that it applies in the annual financial statements. As a result, in the interim financial report, a liability to pay a levy:

  (a) shall not be recognised if there is no present obligation to pay the levy at the end of the interim reporting period; and

  (b) shall be recognised if a present obligation to pay the levy exists at the end of the interim reporting period.

- An entity shall recognise an asset if it has prepaid a levy but does not yet have a present obligation to pay that levy.

2.14 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'UPL Limited' for the financial year 2021 – 2022 with respect to Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets':

35. CONTINGENT LIABILITIES

The Company is involved in a number of appellate, judicial and arbitration proceedings (including those described below) concerning matters arising in the course of conduct of the Company's businesses. Some of these proceedings in respect of matters under litigation are in early stages, and in some other cases, the claims are indeterminate. A summary of claims asserted on the Group in respect of these cases have been summarised below.

Amounts in respect of claims asserted by various revenue authorities on the Company, in respect of taxes, which are in dispute, have been tabulated below:

₹ in Crores

	As at March 31, 2022	As at March 31, 2021
Disputed Income-Tax Liability (excluding interest)	26	33
Disputed Excise Duty / Service Tax liability (excluding interest)	182	186
Disputed Sales Tax/ GST liability	20	25
Disputed Custom Duty liability	22	22
Disputed Fiscal Penalty for cancellation of licenses	33	33
Claims against the Company not acknowledged as debts	1	4

The management believes that the claims made are untenable and is contesting them. As of the reporting date, the management is unable to determine the ultimate outcome of above matters. However, in the event the revenue authorities succeed with enforcement of their assessments, the Company may be required to pay some or all of the asserted claims and the consequential interest and penalties, which would reduce net income and could have a material adverse effect on net income in the respective reported period.

Management is generally unable to reasonably estimate a range of possible loss for proceedings or disputes other than those included in the estimate above, including where:

i. plaintiffs / parties have not claimed an amount of money damages, unless management can otherwise determine an appropriate amount;

ii. the proceedings are in early stages;

iii. there is uncertainty as to the outcome of pending appeals or motions or negotiations;

iv. there are significant factual issues to be resolved; and/or

v. there are novel legal issues presented.

However, in respect of the above matters, management does not believe, based on currently available information, that the outcomes of the litigation, will have a material adverse effect on the Company's standalone financial condition, though the outcomes could be material to the Group's operating results for any particular period, depending, in part, upon the operating results for such period.

(Source: Annual Report of financial year 2021 – 2022 of UPL Limited')

2.15 SIGNIFICANT DIFFERENCES IN IND AS 37 VIS-A-VIS AS 29

S. No.	Particulars	Ind AS 37	AS 29
1.	*Constructive obligations*	Ind AS 37 explicitly defines the term 'constructive obligations' and uses term in certain paragraphs.	Paragraph 11 of AS 29 included expression similar to constructive obligations in the context of explaining when the obligations arise i.e. obligation also arises from normal business practices, custom and a desire to maintain good business relations or to act in an equitable manner.
2.	*Discounting*	Ind AS 37 requires discounting the amounts of provisions, if effect of the time value of money is material.	AS 29 prohibits discounting the amounts of provisions except in case of decommissioning, restoration and similar liabilities that are recognised as cost of property, plant and equipment.
3.	*Contingent asset*	Ind AS 37 requires disclosure of contingent assets in the financial statements when the inflow of economic benefits is probable. The disclosure, however, should avoid misleading indications of the likelihood of income arising.	AS 29 prohibits disclosure of a contingent asset in the financial statements and mentions that it is usually disclosed in the report of the approving authority, where an inflow of economic benefits is probable.
4.	*Onerous Contracts*	Ind AS 37 makes it clear that before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36.	There is no such specific provision in the existing standard.
5.	*Future Operating Losses*	Ind AS 37 gives an exception to this principle viz. such losses related to an onerous contract.	AS 29 states that identifiable future operating losses up to the date of restructuring are not included in a provision.

6.	*Additional guidance*	Ind AS 37 gives guidance on: (a) Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds (b) Liabilities arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment (c) Levies (imposed by government).	AS 29 does not give such guidance.

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Questions

1. X Ltd. is operating in the telecom industry. During the Financial Year 20X1-20X2, the Income Tax authorities sent a scrutiny assessment notice under Section 143(2) of the Income-tax Act, 1961, in respect to return filed under Section 139 of this Act for Previous Year 20X0-20X1 (Assessment Year 20X1-20X2) and initiated assessment proceedings on account of a deduction claimed by the company which in the view of the authorities was inadmissible.

   During the financial year 20X1-20X2 itself, the assessment proceedings were completed and the assessing officer did not allow the deduction and raised a demand of ₹ 1,00,00,000 against the company. The company contested such levy and filed an appeal with the Appellate authority. At the end of the financial year 20X1-20X2, the appeal had not been heard. The company is not confident whether that the company would win the appeal. However, the company was advised by its legal counsel that on a similar matter, two appellate authorities of different jurisdictions had given conflicting judgements, one in favour of the assessee and one against the assessee. The legal counsel further stated it had 50% chance of losing the appeal.

   Advise how the company should account for these transactions in the financial year 20X1-20X2.

2. An entity is a telecom operator. Laying of cables across the world is a requirement to enable the entity to run its business. Cables are also laid under the sea and contracts

are entered into for the same. By virtue of laws of the countries through which the cable passes, the entity is required to restore the sea bed at the end of the contract period.

State the nature of obligation that the entity has in such a case.

3. U Ltd. is a large conglomerate with a number of subsidiaries. It is preparing consolidated financial statements as on 31st March 20X2 as per the notified Ind AS. The financial statements are due to be approved for issue on 15th May 20X2. Following are a few transactions that have taken place in some of its subsidiaries during the year:

   G Ltd. is a wholly owned subsidiary of U Ltd. engaged in management consultancy services. On 31st January 20X2, the board of directors of U Ltd. decided to discontinue the business of G Ltd. from 30th April 20X2. They made a public announcement of their decision on 15th February 20X2.

   G Ltd. does not have many assets or liabilities and it is estimated that the outstanding trade receivables and payables would be settled by 31st May 20X2. U Ltd. would collect any amounts still owed by G Ltd.'s customers after 31st May 20X2. They have offered the employees of G Ltd. termination payments or alternative employment opportunities.

   Following are some of the details relating to G Ltd.:

   - On the date of public announcement, it is estimated by G Ltd. that it would have to pay ₹ 540 lakhs as termination payments to employees and the costs for relocation of employees who would remain with the Group would be ₹ 60 lakhs. The actual termination payments totalling to ₹ 520 lakhs were made in full on 15th May 20X2. As per latest estimates made on 15th May 20X2, the total relocation cost is ₹ 63 lakhs.

   - G Ltd. had taken a property on lease, which was expiring on 31st March 20X6. The present value of the future lease rentals (using an appropriate discount rate) is ₹ 430 lakhs. On 15th May 20X2, G Ltd. made a payment to the lessor of ₹ 410 lakhs in return for early termination of the lease.

   The loss after tax of G Ltd. for the year ended 31st March 20X2 was ₹ 400 lakhs. G Ltd. made further operating losses totalling ₹ 60 lakhs till 30th April 20X2.

   Determine the provisions that the Company is required to make as per Ind AS 37?

4. A company manufacturing and supplying process control equipment is entitled to duty draw back if it exceeds its turnover above a specified limit. To claim duty drawback, the company needs to file application within 15 days of meeting the specified turnover. If application is not filed within stipulated time, the Department has discretionary power of

giving duty draw back credit. For the year 20X1-20X2 the company has exceeded the specified limit of turnover by the end of the reporting period. However, duty drawback can be claimed on filing of application within the stipulated time or on discretion of the Department if filing of application is late. The application for duty drawback is filed on 20th April, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition. Duty drawback has been credited by the Department on 28th June, 20X2 and financial statements have been approved by the Board of Directors of the company on 26th July, 20X2.

Identify the treatment of duty drawback credit as per the given information.

5. Entity XYZ entered into a contract to supply 1000 television sets for ₹ 2 million. An increase in the cost of inputs has resulted into an increase in the cost of sales to ₹ 2.5 million. The penalty for non- performance of the contract is expected to be ₹ 0.25 million.

   Evaluate whether the contract is onerous and also determine the amount of provision to be made in this regard.

Answers

1. Ind AS 37 provides that in rare cases it not clear whether there is a present obligation, for example, in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity should determine whether a present obligation exits at the end of the reporting period by taking account of all available evidence, for example, the opinion of experts.

In the present case, the company is not confident that whether it would win the appeal. By taking into account the opinion of the legal counsel, it is not sure that whether the company would win the appeal. On the basis of such evidence, it is more likely than not that a present obligation exists at the end of the reporting period. Therefore, the entity should recognise a provision. The company should provide for a liability of ₹ 1,00,00,000.

2. Paragraph 14 of Ind AS 37 states that 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.

Further, with regard to past event paragraph 17 of Ind AS 37 states that a past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation."

On the basis of the above, provision should be recognised as soon as the obligating event takes place because the entity is under legal obligation to restore the sea bed, provided the other recognition criteria stated in paragraph 14 reproduced above are met. Moreover, the amount of the provision would depend on the extent of the obligation arising from the obligating event. In the instant case, an obligating event is the laying of cables under the sea. To the extent the cables have been laid down under the sea, a legal obligation has arisen and to that extent provision for restoration of sea bed should be recognised.

3. A discontinued operation is one that is discontinued in the period or classified as held for sale at the year end. The operations of G Ltd were discontinued on 30th April 20X2 and therefore, would be treated as discontinued operation for the year ending 31st March 20X3. It does not meet the criteria for held for sale since the company is terminating its business and does not hold these for sale.

As per para 72 of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', restructuring includes sale or termination of a line of business. A constructive obligation to restructure arises when:

(a) an entity has a detailed formal plan for the restructuring

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

The Board of directors of U Ltd have decided to terminate the operations of G Ltd. from 30th April 20X2. They have made a formal announcement on 15th February 20X2, thus creating a valid expectation that the termination will be implemented. This creates a constructive obligation on the company and requires provisions for restructuring.

A restructuring provision includes only the direct expenditures arising from the restructuring that are necessarily entailed by the restructuring and are not associated with the ongoing activities of the entity.

The termination payments fulfil the above condition. As per Ind AS 10 'Events after Reporting Date', events that provide additional evidence of conditions existing at the reporting date should be reflected in the financial statements. Therefore, the company should make a provision for ₹ 520 lakhs in this respect.

The relocation costs relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Hence, these would be recognised on the same basis as if they arose independently of a restructuring.

The lease would be regarded as an onerous contract. A provision would be made at the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Hence, a provision shall be made for ₹ 410 lakhs.

Further operating losses relate to future events and do not form a part of the closure provision.

Therefore, the total provision required = ₹ 520 lakhs + ₹ 410 lakhs = ₹ 930 lakhs

4. In the instant case, the condition of exceeding the specified turnover was met at the end of the reporting period and the company was entitled for the duty drawback. However, the application for the same has been filed after the stipulated time. Therefore, credit of duty drawback was discretionary in the hands of the Department. Since the claim was to be accrued only after filing of application, its accrual will be considered in the year 20X2-20X3 only.

Accordingly, the duty drawback credit is a contingent asset as at the end of the reporting period 20X1-20X2, which will be realised when the Department credits the same.

As per para 35 of Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset.

In accordance with the above, the duty drawback credit which was contingent asset for the financial year 20X1-20X2 should be recognised as asset and related income should be recognized in the reporting period in which the change occurs. i.e., in the period in which realisation becomes virtually certain, i.e., financial year 20X2-20X3.

5. Ind AS 37 *"Provisions, Contingent Liabilities and Contingent Assets"* defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Paragraph 68 of Ind AS 37 states that 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.

In the instant case, cost of fulfilling the contract is ₹ 0.5 million (₹ 2.5 million – ₹ 2 million) and cost of exiting from the contract by paying penalty is ₹ 0.25 million.

In accordance with the above reproduced paragraph, it is an onerous contract as cost of meeting the contract exceeds the economic benefits.

Therefore, the provision should be recognised at the best estimate of the unavoidable cost, which is lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it, i.e., at ₹ 0.25 million (lower of ₹ 0.25 million and ₹ 0.5 million).