Chapter 2G

Accounting Process – Provisions, Contingent Liabilities and Contingent Assets

CHAPTER OVERVIEW

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The Concepts of Provisions, Contingent Assets and Contingent Liabilities are covered in "ACCOUNTING STANDARD – 29". At Foundation Level, Students are advised to have a general understanding of the meanings of the above terms along with examples. Detailed discussions of these are dealt at Inter Level.

Hence, it is insisted that the Students concentrate ONLY on remembering the definition and the examples.

Glossary of Significant Terms

Contingency	A situation, which **has not actually occurred but** which is **expected to happen** in the near future.
Liability	**Obligation to pay** for any expenses / losses i.e. It represents outflow of business resources
Obligation	Compulsion to pay in future
Probable	Chance of occurrence of an event is ≥ 50%. i.e. an even is more likely to happen
Possible	Chance of occurrence of an event is < 50% i.e. an even may or may not happen. It cannot be determined.
Present Obligation	An obligation which is probable i.e. it is more than likely that such obligation exists on the date of balance sheet is called "Present Obligation"
Possible Obligation	An obligation which is not probable i.e. on the balance date, it is not likely that such obligation may arise in future
Economic Resources	Cash, Assets etc which belong to the business. The benefits derived from these are called as "Economic Benefits"
Recognised	It means "Accounted". i.e. Journal Entries are passed in the Accounts Books
Disclosed	It means "Stated" i.e A statement is given describing the nature of event. Journal Entries are **NOT passed.**

1.1 Provisions

1. **Meaning**	A Provision is *"a Present Obligation, as a result of past events, which leads to probable outflow of resources embodying economic benefits and a reliable estimate of the amount of the obligation can be made"*
2. **Illustration**	***Refer Para 1.2 below for detailed example for "Provision".***
3. **Features**	(a) Provision is a **present liability** of a certain / uncertain amount. (b) Provision **can** be reasonably measured using a substantial degree of estimation.
4. **Treatment**	Provision should be **recognized** in the Books of Accounts and **also disclosed.**
5. **Impact on Profits**	Provision represents a **liability for an expense / loss**; So, Provision **reduces** the profit.
6. **Nature of Account**	Provision is made for liability; Hence, it is in the nature of **Representative Personal Account**, which indirectly represents a person / creditor

7.	**Journal Entry**	**Debit** – Profit and Loss A/c Dr. **Credit** – To Provisions for Liabilities A/c
8.	**Reasoning**	**Debit Aspect:** Provision is an expense / loss, which reduces the profits of the enterprise. Hence, Profit and Loss A/c is debited. (Debit all expenses and losses) **Credit Aspect:** Provision is a liability payable in future. Hence, it is credited (Credit the giver of benefit)
9.	**Disclosure**	For every Provision, following should be disclosed – (a) Opening and Closing Balance, (b) Addition in the year, (c) Amount used, (d) Unused amount reversed during the period.
10.	**Balance Sheet**	Provision is **either shown** (a) **on the liabilities** side **(or)** (b) on the **assets side – as a deduction from the relevant asset**.
11.	**Examples**	(a) Provision for Guarantees Given, when the original debtor becomes insolvent. (b) Provision for Warranties (c) Provision for Discount on Debtors (d) Provision for Bad and Doubtful Debts (e) Other Similar Provisions
12.	**Approving Authority**	Persons who approve and authenticate the Financial Statements of an enterprise. **Example:** Proprietorship Firm – Proprietor; Partnership Firm – Partner; Company – Board of Directors

1.2 Illustration for Provisions

1. **Situation:** M/s A and Co. is involved in extraction of coals from coal mines. While operating in a particular mine, landslide happened and because of this 10 employees of M/s A and Co. died on 15.03.2018. The Financial Position (i.e. Assets and Liabilities) is ascertained on 31.03.2018.

2. **Analysis:** In this situation, M/s A and Co. has an obligation to compensate the families of the dead employees, as the deaths happened while working at its site. Though, A & Co. has not actually compensated the families, it has an **obligation to compensate them**.

3. **Explanation:** The question is whether the **obligation to compensate to be treated as liability** on 31.03.2018. The answer is "YES" i.e. it should be treated as liability as it satisfies the definition of the term "Provision". (as given below)

Conditions from Definition		**Description**
(a)	Present Obligation (Refer meaning in Glossary)	On 31.03.2018, Sufficient evidence is available that M/s A & Co. will compensate the families of dead employees **in future.** If it does not compensate, then anyway the court will intervene and ask the concern to compensate the families
(b)	As a result of Past Events	The obligation to pay compensation arises because of the death of the employees on 15.03.2018. The event of landslide on 15.03.2018 is a past event on 31.03.2018.
(c)	Probable Outflow of Economic Resources	Due to above obligation, M/s A and Co. has to pay cash / other considerations to the families
(d)	Reliable estimate of obligation	M/s A & Co. can determine the **AMOUNT of liability that should be paid.** It will be able to **ESTIMATE** the amount to be paid. Accurate calculations are not required. For eg. No. of employees dead x Compensation per dead = 10 x 5 Lakhs = ₹50 Lakhs

Note: If all the four conditions are satisfied, then a provision has to be created. Hence, in the given example, **"Provision for Compensation to employees"** has to be created for ₹50 Lakhs.

Journal Entry:	Profit and Loss A/c Dr.	50 Lakhs
	To Provision for Compensation to Employees A/c	50 Lakhs

1.3 Contingent Liability

Contingent Liability is ....

a Possible Obligation		Present Obligation
that arises from past events and the existence of which will be confirmed only by the occurrence or non–occurrence of one or more **uncertain** future events not wholly within the control of the enterprise.	**OR**	that arises from past events **but is not recognised** because – • it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or • a reliable estimate of the amount of obligation cannot be made.
An Obligation is a Possible Obligation if, based on the evidence available, its existence at the Balance Sheet date is **considered not probable.**		An Obligation is a Present Obligation if, based on the evidence available, its existence at the Balance Sheet date is **considered probable,** i.e. more likely than not.

Note: Possible Obligation is always a Contingent Liability, whereas Present Obligation becomes a Contingent Liability if the recognition criteria of a **Provision** are not satisfied.

Example: Refer Illustration for Contingent Liability under Para 1.4

1.4 Features of Contingent Liability

1. **No Recognition**	An Enterprise **should NOT RECOGNISE** a Contingent Liability.	
2. **Disclosure**	A Contingent Liability should be **DISCLOSED as a FOOT NOTE to the Balance Sheet.**	
3. **Periodical Review**	Contingent Liability should be **periodically reviewed**. On such review, if the character of the Contingent Liability is found to be changed and there is a probable outflow resources, then it will be recognized as a Provision and treated accordingly.	
4. **Impact**	Contingent Liability **will NOT AFFECT the profits** of the concern, as it is not accounted in Books.	
5. **Examples**	(i) Outcome of a law suit (ii) Claims against the business, not acknowledged as debts (iii) Guarantees given, if the principal debtor is solvent	(iv) Uncalled Liability on Partly Paid shares (v) Arrears of Fixed Cumulative dividends (vi) Workmen Compensations under Dispute (vii) Unspecified Business Risk (viii) Liability on Bills Discounted

Note: Students may note the difference between Recognition & Disclosure. A Provision should be **recognised** and also **disclosed**. However, a Contingent Liability should **not be recognized, but only disclosed.**

1.5 Illustration for Contingent Liability

1. **Situation:** M/s A & Co. produced and sold "MS Windows" Software. Microsoft filed a legal suit against A & Co. for violation of copyrights. Microsoft also claimed damages from A & Co. for producing this without its permission. M/s A & Co. argued in the Court that it has not violated the copyrights. On 31.03.2018, this case is pending in the Court.
2. **Analysis:** The liability for M/s A & Co. may or may not arise based on the decision of the Court. The Court's decision cannot be controlled by A & Co. nor can it be influenced. If the Court decides that A & Co. has not violated any Copyrights, then there is no liability for A & Co.
3. **Explanation:** The liability of M/s A & Co. under the above legal suit is a Contingent Liability and **NOT provision** due to following reasons:

Conditions from Definition	Description
(a) Possible Obligation (Refer Glossary)	On 31.03.2018, Sufficient evidence is **NOT** available that A & Co. will pay damages to Microsoft. It is not conclusive whether the Court's decision will be favourable or unfavourable to A & Co. Hence, there is **no probability** of any **future liability**.

Conditions from Definition		Description
(b)	As a result of Past Events	The above legal suit is due to the sales of software by the concern in the past.
(c)	Existence confirmed by occurrence or non–occurrence of uncertain future events	M/s A & Co. may or may not have the liability due to copyright violation. This is based on the favourable or unfavourable decision of the Court. One cannot predict the future decision of the Court and hence it is an uncertain event.
(d)	Not within the control of the Enterprise	The decision of the Court is not within the control of M/s A & Co. The Court will decide based on the facts of the case, the arguments of the parties and its knowledge.

Note: If all the above 4 conditions are satisfied, then the liability is in the nature of **"Contingent Liability"**. Hence, in the example, **"Contingent Liability due to legal suits pending at the Court"** has to be **disclosed** as a **foot note** to the Balance Sheet. There is no Journal Entry. Only a statement describing the liability is given at the end of Balance Sheet.

1.6 Provisions vs Contingent Liabilities

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Particulars	Provision	Contingent Liability
1. **Meaning**	Provision is a **present Obligation** of a certain / uncertain amount.	It is a **possible obligation** which arises from past event.
2. **Measurement**	Provision **can** be reasonably measured using a substantial degree of estimation.	Contingent Liability **cannot** be reasonably measured.
3. **Recognition**	Provision should be **recognized** in the Books of Accounts.	Contingent Liability should **not** be recognized in the Books of Accounts.
4. **Impact on Profit**	A known liability is accounted. Hence, a Provision **reduces** the profit.	Contingent Liability is **not** accounted. It has **no impact** on profits for the period.
5. **Disclosure**	For every Provision, the following **should also be disclosed** – (a) Opening & Closing Balance, (b) Addition during the year, (c) Amount used, (d) Unused amount reversed during the period.	Contingent Liability is **only disclosed by way of a Footnote to the Balance Sheet**, or as a separate Schedule / Annexure thereto.

1.7 Contingent Assets – Meaning and Features

1. **Meaning**	A Contingent Asset is a **POSSIBLE ASSET** that **arises from past events**, existence of which **will be confirmed only by occurrence / non–occurrence** of one or more **uncertain future events, not wholly within the control** of the enterprise.
2. **Treatment**	An enterprise **SHOULD NOT RECOGNISE** a Contingent Asset due to **CONSERVATISM** Convention. Because this may result in recognition of income that may never be realized.
3. **Impact**	Contingent Assets will not affect the profits of the enterprise as it is not accounted in the books.
4. **Certainty**	If the realisation of income is certain, then it is not a Contingent Asset and the same shall be recognized in the Financial Statements.
5. **Disclosure**	Contingent Assets **should not be disclosed in the Financial Statements** but **may be disclosed** in the **Report of the Approving Authority (Refer Glossary).**
6. **Examples**	(i) Unplanned or unexpected events leading to possibility of inflow of economic benefits. (ii) Expected Gain from a legal suit. (iii) Insurance claims for damage of a property

1.8 Illustration for Contingent Assets

1. **Situation: Take the same situation as given under Contingent Liabilities.** Microsoft filed a legal suit against A & Co. for violation of copyrights. Microsoft also claimed damages from A & Co. for the producing without its permission. M/s A & Co. argued in Court that it has not violated the copyrights. On 31.03.2018, this case is pending in the Court.
2. **Analysis: FROM THE VIEW OF MICROSOFT,** it may or may not receive compensation from M/s A & Co. based on the decision of the Court. The Compensation is a **possible gain for Microsoft.**

3. **Explanation:** The Compensation from M/s A & Co. is a **Contingent Asset for Microsoft** due to following reasons –

Conditions from Definition	**Description**
(e) Possible Obligation (Refer Glossary)	On 31.03.2018, Sufficient evidence is **NOT** available that Microsoft will receive money from M/s A & Co. Hence it is only a possible asset.
(f) As a result of Past Events	The above gains may arise because M/s A & Co. has violated the copyrights in the past.
(g) Existence confirmed by occurrence or non–occurrence of uncertain future events	Microsoft may or may not receive money from M/s A & Co. This is based on the favourable or unfavourable decision of the Court. One cannot predict the future decision of the Court and hence it is an uncertain event.
(h) Not within the control of the enterprise	The decision of the Court is not within the control of M/s A & Co. The Court will decide based on the facts of the case, the arguments of the parties and its knowledge.
Note: If all the above 4 conditions are satisfied, then the **Gains** are in the nature of **"Contingent Asset"**. Hence, in the example, **"Contingent Asset due to Legal Suit filed for Copyrights Violation" MAY** be **disclosed** in the report of the **Board of Directors of Microsoft**. It is not accounted / disclosed in accounts books.	

1.9 Principles behind Provisions, Contingent Liabilities and Assets

Nature	**Principle**
1. **Provision**	Matching Concept, Conservatism Convention
2. **Contingent Liability**	Full Disclosure Concept
3. **Contingent Asset**	Conservatism Convention

1.10 Contingent Assets vs Contingent Liabilities.

Particulars	**Contingent Assets**	**Contingent Liabilities**
1. **Meaning**	Refer Para 1.7 above	Refer Para 1.3 above
2. **Nature**	Contingent Asset is a possible asset.	Contingent Liability is a possible obligation
3. **Recognition**	Should **not** be recognized in the B/ Sheet.	Should **not** be recognized in the B/ Sheet.
4. **Disclosure**	Should **not** be disclosed in the Balance Sheet. But it may be disclosed in the report of the approving authority.	Should be **disclosed** in the Balance Sheet, as a Footnote or as a separate Schedule.

Note: Contingent Situation is a situation, in which the ultimate outcome, (whether gain or loss) will known only on the occurrence or non–occurrence, of one or more uncertain future event. So, both Contingent Assets and Contingent Liabilities –

(a) arise from past events,

(b) existence will be confirmed only by the occurrence or non–occurrence of one or more uncertain future event, and

(c) such event is not wholly within the control of the enterprise.

1.11 Liabilities vs Contingent Liabilities.

Particulars	**Liability**	**Contingent Liability**
1. Meaning	It is the **present** financial obligation of an enterprise, which arises from past events.	Contingent Liability is a **Possible** obligation which arises from a past event.
2. Example	Wages, Salaries, Rent, Electricity, etc. for the last month of the financial year, but paid in first month of next financial year.	• Claims against enterprise not acknowledged as Debts. • Guarantees given in respect of third parties, • Liability in respect of Bills Discounted.
3. Measure–ment	It **can** be measured with a reasonable degree of estimation.	It **cannot** be measured with a reasonable degree of estimation.
4. Disclosure	**Disclosed** in the Liability Side of the Balance Sheet and hence it is part of Balance Sheet.	**Not a part of Balance Sheet**. It is only disclosed by way of Footnote to the Balance Sheet.
5. Effect on Profit	A known liability is provided for, i.e. it **reduces** the profit.	Contingent Liability is **not** provided for. It has **no impact** on profits for the period.