Educational Material on Indian Accounting Standard (Ind AS) 37 Provisions, Contingent Liabilities and Contingent Assets (Revised 2016)

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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This Educational Material has been formulated in accordance with the Ind AS notified by the Ministry of Corporate Affairs (MCA) as Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 and other amendments finalised subsequent to the notification.

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Foreword

With a view to achieve international benchmarks of financial reporting, the Institute of Chartered Accountants of India (ICAI), as a proactive role in accounting, formulated Indian Accounting Standards (Ind AS) converged with the International Financial Reporting Standards (IFRS). The Ministry of Corporate Affairs (MCA) has notified these Ind AS as Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 and also the roadmap for the applicability of Ind AS for companies. The MCA has also issued a press release on January 18, 2016, announcing the Ind AS roadmap for Scheduled Commercial Banks (excluding RRBs), Insurers/Insurance companies and Non-banking Financial Companies (NBFCs) from the financial year 2018-19.

Considering these major developments, the Institute of Chartered Accountants of India through its Ind AS (IFRS) Implementation Committee, is making relentless efforts to provide necessary support and guidance to members and other stakeholders for proper implementation of Ind AS. Moving forward in this direction, the Committee has revised its Educational Material on Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets. The purpose of this Educational Material is to provide guidance by way of Frequently Asked Questions (FAQs) explaining the principles enunciated in the Standard.

I convey my heartfelt thanks to CA. S.B. Zaware, Chairman, CA. Vijay Kumar Gupta, Vice-chairman and all Co-opted Members and Special invitee of the Ind AS (IFRS) Implementation Committee for bringing out this publication.

I sincerely believe that this revised Educational Material will be of immense use to the members and others concerned in proper understanding and implementing the Standard. I am confident that all these efforts will be very useful for smooth transitioning to Ind ASs in India.

New Delhi
February 9, 2016

CA. Manoj Fadnis
President, ICAI

Preface

In addition to the formulation of IFRS-converged Ind AS, the ICAI through its Ind AS (IFRS) Implementation Committee is making every possible effort to ensure that these Standards are implemented in the same spirit in which these have been formulated. For this purpose, the Committee is working to provide guidance to the members and other stakeholder by issuing Educational Materials on Ind ASs apart from conducting IFRS Certificate Course, workshops, seminars, awareness programmes, and series of webcasts, etc.

During the Council Year 2015-16, the Committee decided to revise certain Educational Materials issued earlier since there are substantial changes in certain Ind AS notified in 2015 compared to the Ind AS notified in 2011. Working in this direction, the Committee has brought this revised Educational Material on Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Ind AS 37 lays down the principles for appropriate recognition, measurement and disclosure of provisions. Ind AS 37 requires to disclose certain information regarding provisions, contingent liabilities and contingent assets, in the notes to enable users to understand their nature, timing and amount. Appropriate recognition and disclosures in this regard are essential to ensure that the financial statements reflect true and fair view of the entity's financial position and financial performance.

This revised Educational Material contains summary of Ind AS 37 discussing the key requirements of the Standard in brief and the Frequently Asked Questions (FAQs) covering the issues, which are expected to be encountered frequently while implementing this Standard.

I may mention that the views expressed in this publication are the views of the Ind AS (IFRS) Implementation Committee and are not necessarily the views of the Council of the Institute. The purpose of this publication is to provide guidance for implementing this Ind AS effectively by explaining the principles enunciated in the Standard with the help of examples. However, while applying Ind ASs in a practical situation, reference should be made to the text of the Standards.

I would like to convey my sincere gratitude to our Honourable President CA. Manoj Fadnis and Vice-President CA. M. Devaraja Reddy for providing me this opportunity of bringing out implementation guidance on Ind ASs in the form of Educational Materials. I wish to place on record my sincere appreciation of CA. Vijay Kumar Gupta, Vice-Chairman, CA. Sanjeev Singhal, CA. Savita Gupta and other members of the Study Group, for preparing the revised draft of this Educational Material. I would also like to thank all members, co-opted members, special invitees of the Ind AS (IFRS) Implementation Committee for their invaluable suggestions and contributions for finalising this publication.

I am confident that this revised Educational Material will be of immense use in understanding the provisions of Ind AS 37 and in implementation of the same.

New Delhi
February 9, 2016

CA. S. B. Zaware
Chairman
Ind AS (IFRS) Implementation Committee

Foreword to the First Edition

Financial statements of an entity represent its financial position and financial performance as on a reporting date. Financial statements should be comparable not only with the entity's own financial statements of previous periods but also with the financial statements of other entities. In the present era of globalisation, where cross border movement of capital is increasing and the users of the financial statements of an entity are no longer limited to single country of business, it is increasingly being felt that financial statements should be comparable with other entities across the globe. In order to achieve this objective, the accounting principles for reporting financial information should be identical in all the countries. All this has necessitated the establishment of a single set of globally accepted financial reporting system. The International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) are increasingly being recognised as global financial reporting standards.

In addition to improved and more comparable financial reporting, many other substantial benefits have been proposed by the convergence with IFRS, including a decreased cost of capital due to greater mobility of capital, greater efficiency in the allocation of resources, etc. Considering all these global developments, India decided to converge with IFRS. For this purpose, IFRS-converged Indian Accounting Standards corresponding to IFRS, considered relevant as on 1st April, 2011, have been formulated by the Institute of Chartered Accountants of India (ICAI). The same have been placed by the MCA on its website after the recommendation of the National Advisory Committee on Accounting Standards (NACAS).

Considering these major developments, the Institute of Chartered Accountants of India has constituted a non-standing Committee, namely, Ind AS (IFRS) Implementation Committee, to provide necessary support and guidance to members and other stakeholders to get themselves ready for proper implementation of IFRS-converged Indian Accounting Standards. The Committee is accordingly working to provide necessary guidance on IFRS-converged Indian Accounting Standards. Moving forward in this direction, the Ind AS (IFRS) Implementation Committee has formulated Educational Material on Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets. The purpose of this Educational Material is to provide guidance by way of Frequently Asked Questions (FAQs) explaining the principles enunciated in the Standard.

I would like to place on record my appreciation for the sincere efforts of the entire Committee under the dynamic Chairmanship of CA. Amarjit Chopra for bringing out this publication.

I am confident that this Educational Material will be very useful not only to the members of the profession but also to other concerned stakeholders in proper understanding and implementation of the Standard.

New Delhi
February 3, 2012

CA. G. Ramaswamy
President

Preface to the First Edition

International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) are widely recognised as global financial reporting standards. These are not country-specific Standards. India has decided to converge with IFRS issued by the IASB. For this purpose, the Institute of Chartered Accountants of India (ICAI), being the premier accounting body in the country, has been actively engaged in the formulation of IFRS-converged Indian Accounting Standards (Ind ASs).

In addition to the formulation of IFRS-converged Indian Accounting Standards, the ICAI is making every possible effort to ensure that these Standards should be implemented in the same spirit in which they have been formulated. For this purpose, ICAI has recently constituted a Committee, namely, Ind AS (IFRS) Implementation Committee, to deal with all types of implementation issues involved in these Standards. In order to provide implementation guidance, the Committee is actively engaged in formulation of Educational Materials on Indian Accounting Standards. The Committee has brought out the Educational Material on Indian Accounting Standard (Ind AS) 37, Provisions, Contingent Liabilities and Contingent Assets.

Indian Accounting Standard (Ind AS) 37, Provisions, Contingent Liabilities and Contingent Assets lays down the principles for appropriate recognition, measurement and disclosure of provisions. Ind AS 37 requires an entity to disclose certain information regarding provisions, contingent liabilities and contingent assets, in the notes to enable users to understand their nature, timing and amount. Appropriate recognition and disclosures in this regard are essential to ensure that the financial statements reflect true and fair view of the entity's financial position and financial performance.

This Educational Material contains summary of Ind AS 37 discussing the key requirements of the Standard in brief and the Frequently Asked Questions (FAQs) covering the issues, which are expected to be encountered frequently while implementing this Standard, such as, distinction between accrual and provision, provision and contingent liability, and their appropriate recognition. The text of Ind AS 37 has been included as an Appendix to make this publication comprehensive.

I may mention that the views expressed in this publication are the view of the Ind AS (IFRS) Implementation Committee and are not necessarily the views of the Council of the Institute. The purpose of this publication is to provide guidance for implementing this Ind AS effectively by explaining the principles enunciated in the Standard with the help of examples. However, while applying Ind ASs in a practical situation, reference should be made to the text of the Standards.

I would like to convey my sincere thanks to our Honourable President CA. G. Ramaswamy and Vice-President CA. Jaydeep N. Shah for providing me this opportunity of bringing out implementation guidance on Ind ASs in the form of Educational Materials. I wish to place on record my sincere appreciation of the efforts put in by CA. Samir R. Shah, Convenor of the Study Group constituted to prepare the draft of this Educational Material, CA. Sampada S. Narvankar and other members of the Study Group, in developing the draft of this Educational Material. I would like to thank my Council colleagues, co-opted members and special invitees on the Ind AS (IFRS) Implementation Committee for their valuable inputs.

I would like to thank Dr. Avinash Chander, Technical Director, CA. Parminder Kaur, Secretary, Ind AS (IFRS) Implementation Committee and CA. Bibhuti Bhusan Nayak, Executive Officer, for their efforts and support for finalising this publication.

I hope this Educational Material will be of immense use in understanding the provisions of Ind AS 37 and in implementation of the same.

New Delhi
February 3, 2012

CA. Amarjit Chopra
Chairman
Ind AS (IFRS) Implementation Committee

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Educational Material on Indian Accounting Standard (Ind AS) 37 Provisions, Contingent Liabilities and Contingent Assets

I. Ind AS 37 – Summary

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 that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

Scope

Ind AS 37 shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets. However, this Standard does not apply to:

1 provisions, contingent liabilities and contingent assets resulting from executory contracts, except where the contract is onerous;

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

3 provisions, contingent liabilities or contingent assets which are specifically covered by another Standard. For Example:

   (a) construction contacts covered by Ind AS 11;

   (b) income taxes covered by Ind AS 12;

   (c) leases covered by Ind AS 17, though this Standard applies to operating leases that have become onerous;

   (d) employee benefits covered by Ind AS 19;

   (e) insurance contracts covered by Ind AS 104, though this Standard applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of Ind AS 104; and

(f) contingent consideration of an acquirer in a business combination covered by Ind AS 103, *Business Combinations.*

4 adjustments to the carrying amounts of assets for example provision for depreciation, provision for impairment of assets or provision for doubtful debts.

Key Requirements of Ind AS 37

Recognition

Provisions

The Standard defines a provision as a liability of uncertain timing and amount and prescribes conditions that have to be satisfied for recognition of a provision. A provision shall be recognised when:

- an entity has a present obligation (legal or constructive) that is a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

Present Obligation

In almost all cases it will be clear whether a past event has given rise to a present obligation. Where it is not clear whether there is a present obligation, past event shall be evaluated. A past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is **more likely than not** that a present obligation exists at the end of the reporting period.

If it is more likely that no present obligation exists at the end of the reporting period, the entity discloses a contingent liability unless the possibility of an outflow of resources embodying economic benefits is remote.

Past Event

A past event that leads to a present obligation is called an obligating event. Obligating events are those events 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 creates valid expectations in other parties that the entity will discharge the obligation.

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. As per this Standard, an outflow of resources or other event is regarded as probable if the event is more like than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where there are a number of similar obligations (e.g., product warranties) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

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. 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. 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.

Contingent liabilities

An entity shall not recognise a contingent liability. It is required to be disclosed unless the possibility of an outflow of resources embodying economic benefits is 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 is treated as a contingent liability.

Contingent assets

An entity shall 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. These are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset, where an inflow of economic benefits is probable, shall be disclosed.

Measurement

Best estimate

The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. In other words, the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. The estimates of outcome and financial effects are determined by the judgment of the management of the entity, supplemented by experience and in some cases, reports from independent experts. Events after the reporting period provide additional evidence.

Risks and uncertainties

The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

Present value

Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

Future events

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

Expected disposals of assets

Gains from the expected disposals of assets shall not be taken into account in measuring a provision. These are not recognised even if the expected disposal is closely linked to the event giving rise to the provision.

Reimbursements

When some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall 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.

Changes in provisions

Provisions shall 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 shall be reversed.

Where discounting is used, the increase in provision due to passage of time shall be recognised as borrowing cost.

Application of the recognition and measurement rules

Onerous contracts

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

Restructuring obligations

A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met.

With respect to restructuring obligation, the Standard provides guidance for application of general recognition conditions that need to be complied with for recognition of restructuring provision and identification of expenses that are in the nature of restructuring cost.

Disclosure

Following are the disclosure requirements of Ind AS 37:

1. Reconciliation for each class of provision, disclosing opening balance,

additional provision made during the period, amounts charged against the provision, unused amount reversed during the period, impact of discounting, effect of any change in the discounting rate and closing balance. Comparative information is not required to be given.

2. For each class of provision, a brief description of
   - nature;
   - timing of expected outflow;
   - indication of uncertainties about amount and timing;
   - assumptions relating to future events; and
   - expected reimbursement, if any.
3. For each class of contingent liability:
   - description of the nature of contingent liability;
   - an estimate of the financial effect;
   - indication of uncertainties relating to the amount or timing of any outflow; and
   - the possibility of any reimbursement
4. With respect to contingent asset:
   - description of the nature of contingent asset; and
   - if possible, an estimate of the financial effect.
5. Where any of the information required to be disclosed in the context of contingent liabilities and contingent assets is not disclosed because it is not practicable to do so, that fact shall be stated.

Ind AS 37 contains following appendices:

- Appendix A - Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
- Appendix B - Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment[1]

[1] This Appendix is in the context of European Union. However, if similar regulations exist in other countries including India the principles as enunciated in this Appendix shall apply.

- Appendix C - Levies

Appendix A of Ind AS 37 provides guidance on (a) how a contributor accounts for its interest in a fund and (b) when a contributor has an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor or if the value of the investment assets held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations, how that obligation be accounted for. The Appendix prescribes that the contributor shall recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. When a contributor has an obligation to make potential additional contributions, this obligation is a contingent liability that is within the scope of Ind AS 37. The contributor shall recognise a liability only if it is probable that additional contributions will be made.

Appendix B of Ind AS 37 provides guidance on the recognition, in the financial statements of producers, of liabilities for waste management under the European Union's Directive on Waste Electrical and Electronic Equipment (WE&EE), in respect of sales of historical household equipment. This Appendix addresses neither new waste nor historical waste from sources other than private households. The liability for such waste management is adequately covered in Ind AS 37. However, if, in national legislation, new waste from private households is treated in a similar manner to historical waste from private households, the principles of this Appendix apply by reference to the hierarchy in paragraphs 10-12 of Ind AS 8. The Ind AS 8 hierarchy is also relevant for other regulations that impose obligations in a way that is similar to the cost attribution model specified in the EU Directive.

This Appendix prescribes that participation in the market during the measurement period is the obligating event in accordance with paragraph 14(a) of Ind AS 37. As a consequence, a liability for waste management costs for historical household equipment does not arise as the products are manufactured or sold. Because the obligation for historical household equipment is linked to participation in the market during the measurement period, rather than to production or sale of the items to be disposed of, there is no obligation unless and until a market share exists during the measurement period.

Appendix C addresses the accounting for a liability to pay a levy if that liability is within the scope of Ind AS 37. It also addresses the accounting for a liability to pay a levy whose timing and amount is certain. The Appendix prescribes that obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. An entity does not have a constructive obligation to pay a levy that will be triggered by operating in a future period as a result of the entity being economically compelled to continue to operate in that future period. The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time

II. Frequently Asked Questions

Provisions and other liabilities

Question 1

Determine whether the following obligations will be classified as provisions in the financial statements:

Nature of obligation

(a) Amount payable for utilities like electricity, gas, etc.

(b) Amount payable for goods received but invoice not received

(c) Financial guarantee given by the parent to the bank for loan taken by its subsidiary

(d) Warranty obligation

(e) Accrued interest payable on borrowings

(f) Unearned revenue/Advance received

Response

Nature of obligation	Recognition as provision as per Ind AS 37 (Yes/No)	Reasons
(a) 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/bi-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.
Amount payable for goods or services received but invoice not received	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 obligation	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.
Accrued interest payable on borrowings	No	The amount and timing of payment is known.

Recognition of Provision

Question 2

The entity is an automobile component manufacturer. The automobile manufacturer has specified a delivery schedule, non adherence to which will entail a penalty. As on March 31, 2X16, the reporting date, the manufacturer has a delivery scheduled for June 2X17. However the manufacturer is aware that he will not be able to meet the delivery schedule in June 2X17. Determine whether the entity has a present obligation as at March 31, 2X16, requiring recognition of provision.

Response

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.”

In this case, there is no present obligation arising out of a past event as the goods are scheduled for delivery in June 2X17 and there is no delay as at March 31, 2X15. Hence, there is no present obligation to pay the penalty in the current year. Therefore, no provision can be recognised in the instant case.

Question 3

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. What is the nature of obligation that the entity has in such a case?

Response

Paragraph 14 of Ind AS 37 states “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 “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.

Question 4

Entity A is a dealer in washing machines. Entity A offers to its customers a scheme whereby it states that after a period of 3 years, the entity offers to buy back the washing machine at a fixed price which is expected to be less than the fair value of the machine at the end of three years. The credit emanating therefrom will be required to be used by the customer for buying a new washing machine, i.e., new washing machine will be sold at a discounted price. Past experience indicates that customers generally opt for this scheme. At the time of sale of the first washing machine should entity A recognise any provision in this regard?

Response

Paragraph 14 of Ind AS 37 states "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."

In the instant case, assuming that the entity recognises the entire revenue on the sale of first washing machine, a provision for expected cost of meeting the obligation of selling the second machine at discounted price should be recognised because sale of first washing machine is the past event. Moreover, past experience indicates that customers generally opt for this scheme, therefore, probability of outflow of resources is more likely than not. Since it is a normal practice which the entity follows, reliable estimate of the amount of meeting the obligation can also be made.

Question 5

Entity X who is a retailer in kids' apparels has a policy of offering cash refunds to customers who are not satisfied with the product, even if there is no defect, provided the return is made within 15 days of the sale. Assuming that revenue has been recognised consequent to meeting of revenue recognition criteria of Ind AS 18, should a provision be made by entity X for such offer of cash refunds?

Response

The existence of right to return the goods within 15 days gives rise to a present obligation on entity X. Since obligation in respect of sales return can be estimated reliably on the basis of past experience, a provision in respect of sales returns should be recognised. In accordance with paragraph 36 of Ind AS 37, the provision should be measured as the best estimate of the expected cash refunds.

Question 6

Entity Z has received a regulatory notification during the year from the Ministry of Environment & Forests [MoEF] stating that they have received complaints from environmental activists that a lot of pollution and resultant contamination has been caused by the entity at its manufacturing unit. As a result, the MoEF is proposing to embark on, an investigation into the complaints and depending on outcome, penalty would be levied on the entity.

Consequent to this, the management of entity Z tried to determine whether it has caused any pollution over last 45 years since the establishment of the manufacturing unit. The management is not very sure whether it has caused contamination because records for all the years are not available, but believes that it has not caused contamination based on records for some years that are readily available. As a result, the management is not in a position to assess the responsibility of entity Z until the investigation is completed.

Under such circumstances whether the entity Z is required to make any provision in its books.

Response

Paragraph 15 of Ind AS 37 states "In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period."

In the present case, since the entity does not have all the records and whatever available evidence is there, it is not clear whether a present obligation exists. The obligating event, i.e., a past event that leads to a present obligation would in this case be the past events of contamination and not the investigation *per se*. But the management is not in a position to determine whether pollution has been caused by it until the investigation is complete, i.e., whether past event has given rise to present obligation. In this regard definition of contingent liability may be noted which, inter alia, provides that "A contingent liability 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".

In accordance with the above definition, entity Z should disclose the contingent liability for penalty as imposing of the same depends on the result of investigation and should not recognise any provision for this as at the balance sheet date.

Question 7

What is the meaning of the word "probable" in the context of Ind AS 37?

Response

For the purpose of Ind AS 37, the word 'probable' is defined as 'more likely than not'. 'More likely than not' means that the probability that the event will occur is greater than the probability that it will not occur. A percentage of over 50% chance that the event will occur can be used for this purpose.

The following table summarises some of the situations that may exist, considering various definitions given in Ind AS 37.

Situation	Classification under Ind AS 37
Past event has occurred resulting in a possible obligation for which a transfer of benefits is possible but not probable.	Liability for transfer of benefits should be recognised as contingent liability and not as provision because in this case there is 'possible obligation' and not 'present obligation.'
Past event has occurred resulting in a present obligation for which there may possibly be a transfer of benefits, but the transfer of benefits is not probable.	Liability for transfer of benefits should be classified as contingent liability and not as provision because outflow of resources embodying economic benefits is not probable.
Past event has occurred resulting in a present obligation for which transfer of benefits is probable, which can be measured easily.	Liability for transfer of benefits should be recognised as provision because there is a present obligation, outflow of resources embodying economics benefits is probable, and these can be measured reliably.

Question 8

Entity XYZ is engaged in the manufacture and sale of central chillers. Sale of chillers is subject to a warranty for repairs of manufacturing defects that are identified within two years of sale. Past experience has shown that the entity receives claims for warranty. Is a provision for warranty required under Ind AS 37?

Response

Yes, a separate provision for warranty should be made because:

(a) the entity has a legal obligation which arises on sale of the chiller

(b) Past experience indicates that it is more likely than not that there will be an outflow of economic benefits

(c) Reliable estimate of the obligation can be made based on past experience.

Question 9

When a provision is created, where the corresponding debit should be taken to?

Response

Ind AS 37 does not specifically addresses where the debit corresponding to a provision should be taken to. Therefore, treatment in this regard would be determined in accordance with other relevant Ind AS. Although in most of the cases the debit will be taken to the Statement of Profit and Loss but sometimes recognition of a provision could result in the creation of an asset also. For example, decommissioning obligations relating to creation of a fixed asset that are provided for in the books at the time when the asset comes into existence are normally capitalised and depreciated over the useful life of the asset.

Measurement

Question 10

How the best estimate of the amount of provision is determined?

Response

In accordance with paragraphs 39 and 40 of Ind AS 37, an entity may generally use the following techniques to make the best estimate of the amount of provision:

1. Weighted average of all possible outcomes by their associated probabilities, known as 'expected value' or

2. The single most likely outcome.

Example 1: Weighted average of all possible outcomes
An entity is a retail chain distributing shoes. It faces 200 legal claims filed by its distributors. Each with a 30 per cent likelihood of success with no cost and a 70 per cent likelihood of failure with the cost of each claim to be Rs. 20,000. Using expected value method, the best estimate of the provision should be measured using the following formula: 70% × 200 claims × Rs. 20,000 per claim = Rs 28,00,000.

Example 2: Single most likely outcome
An entity has a legal claim for damages filed by its customer of Rs. 2.50 million. There is a 40% chance that the entity will win the case and no cost will be involved. However, there is a 60% chance that decision will not be in the favour of the entity and it will have to pay for the damages. In this case the outcome will either be zero cost or a cost of Rs. 2.5 million. As per paragraph 40 of Ind AS 37 "where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability." In this example, the provision should be measured at the most likely outcome which is Rs. 2.5 million. When the provision relates to a single event, or a small number of events, expected value is not a valid technique.

Question 11

What factors should be considered while selecting the discount rate that should be used to determine the present value of the expected expenditure?

Response

As per Ind AS 37, provisions should be discounted where the effect of the time value of money is material. For this purpose, discount rate should be pre-tax rate which reflects the current market assessment of time value of money. Government bond rate can be used as discount rate, as it is a risk-free pre-tax rate reflecting the time value of money. This rate should be adjusted to reflect the risks specific to the liability, as Ind AS 37 requires that the discount rate should reflect the risks specific to the liability. However, where future cash flows have been adjusted to reflect risks, the discount rate should not be adjusted to reflect such risks.

Further, as per paragraph 59 of Ind AS 37, provisions should be reviewed at the end of each reporting period and should be adjusted to reflect the change in estimates. For this purpose, the discount rate should also be reassessed at the end of each reporting period, including the interim reporting date, if any.

Question 12

What is the accounting treatment for recognising the impact of unwinding of discounting?

Response

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.

Example: An entity has a legal claim that is likely to be settled at the end of two years for an amount of Rs. 100 million. Assuming a discounting rate of 4.5%, the accounting will be as follows:

	Discounting factor @ 4.5%	NPV (Rs. in Million)	Borrowing cost (Rs. in Million)
	0.9157	91.57	
End of Year 1	0.9569	95.69	4.12
End of Year 2	1	100	4.31

The provision should be initially recognised at Rs. 91.57 million which is the present value of Rs. 100 million discounted at 4.5% for two years. At the end of year 1, the provision increases to Rs. 95.69 million, and the difference of Rs. 4.12 million is recognised as borrowing cost. In year 2, the provision will increase by Rs. 4.31 million, 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., Rs. 100 million.

Question 13

Management is making an assessment of provision required for site cleanup cost. This provision reflects the reasonable expectation of technical experts about the technology that would be available at the time of the clean-up taking into account, all available evidence. Consequently, cost reduction is being recognised for:

— increased experience in applying existing technology; and

— applying existing technology to a larger or more complex clean- up operation than has been carried out to date?

Should an entity take into consideration the impact of future events while determining the amount of provision?

Response

Paragraph 48 of Ind AS 37 requires that future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision when there is sufficient objective evidence that they will occur. Further, paragraph 49 of Ind AS 37 provides that the current provision should reflect the cost reduction arising from technology expected to be available at the time of the future clean-up.

In the instant case, since technical experts have reasonable expectation about the technology that will be available at the time of clean-up would result in cost reduction, the impact of the same should be taken into consideration while determining the amount of provision.

Reimbursements

Question 14

When and how an entity should recognise the reimbursement from third party of some or all of the expenditure required to settle a provision?

Response

As per paragraph 53 of Ind AS 37, a reimbursement from a third party, for full or part of the expenditure required to settle a provision, should be recognised only when it is virtually certain that it will be received by the entity if the entity settles the obligation.

How the entity should recognise the reimbursement will be determined by whether the entity has the primary liability to settle the obligation.

Where the entity is liable to pay the whole amount, even in case of failure by the third party to pay for the amount, provision is recognised for full amount and a separate asset is recognised for the expected reimbursement subject to meeting the virtual certainty criterion. Asset must not exceed the provision amount.

In the Statement of Profit and Loss, the expense for provision may be presented net of the amount of expected reimbursement.

Where the entity is not liable to pay the cost in case of failure to pay by the third party, no provision is required to be made by the entity.

Question 15

Entity XYZ is a power generation entity. In order to meet its decommissioning cost of Rs. 5 million, the entity makes an annual contribution of a fixed amount to a decommissioning fund. As per the fund scheme, in case of failure by the fund to meet the decommissioning obligation, the entity is liable to meet the same. Further, the entity is required to make additional contribution to the fund in case of shortfall in the value of investment assets held by the fund and the decommissioning obligation. As on March 31, 2X16, there is a shortfall in the fund of Rs. 2 million. How should an entity account for its obligation to pay for decommissioning cost to the fund and additional contribution?

Response

Paragraph 7 of Appendix A to Ind AS 37 provides "The contributor shall recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay."

In accordance with the above, entity XYZ should recognise a liability of Rs. 5 million for its obligation to pay for decommissioning cost and the interest in the fund shall be recognised separately.

In accordance with paragraph 10 of Appendix A to Ind AS 37, the amount of shortfall of Rs. 2 million in the investment assets of the fund shall be disclosed as a contingent liability in accordance with the provisions of Ind AS 37. This liability for the shortfall will be recognised only if it is probable that the entity will be required to make additional contributions.

Changes in Provision

Question 16

Will the accounting for a recognised provision undergo a change once the amount payable under the obligation becomes certain?

Response

Ind AS 37 defines a provision as a liability of uncertain timing on amount, accordingly, 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. For example, customer X has made a claim of Rs. 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 Rs. 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.

Onerous Contracts

Question 17

Entity XYZ entered into a contract to supply 1000 television sets for Rs 2 million. An increase in the cost of inputs has resulted into an increase in the cost of sales to Rs. 2.5 million. The penalty for non- performance of the contract is expected to be Rs. 0.25 million. Is the contract onerous and provision in this regard required?

Response

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”. 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 Rs. 0.5 million and cost of exiting from the contract by paying penalty is Rs. 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 Rs. 0.25 million (lower of Rs. 0.25 million and Rs. 0.5 million).

Question 18

An entity has entered into a contract to purchase specific quantity of coal at the rate of Rs. 50 per unit over a period of three years. The contract is not cancellable without payment of compensation. The current market price of coal is Rs. 45 per unit. The coal is purchased for consumption during the manufacturing process the output of which is sold in the market at a profit. Is the contract an onerous contract?

Response

No, the contract is not an onerous contract because the entity will derive economic benefits from the contract including the benefits of using the coal in the manufacturing process and the final product will be sold in the market at a profit.

Question 19

Assume the same conditions as in question 18 above except that the final product is sold in the market at loss and the loss is primarily on account of high cost of coal. In this case, is the contract an onerous contract?

Response

In this case, since the entity is making losses in the contract and the contract is not cancellable without payment of compensation, the contact is onerous. Therefore, as per paragraph 66, the present obligation under the contract should be recognised and measured as provision.

Restructuring

Question 20

Entity A is in the process of finalising a restructuring plan. As a result it is likely that there will be closure of two units, a reduction in head count, potential new hires and additional training for developing new skills. Additionally, they are proposing hiring a new manager for whom the entity will have to bear relocation cost. The entity proposes to sell the assets at the unit on closure. Which of the following costs should be included while determining the provision for restructuring:

- Cost of employee termination
- Staff training cost
- Recruitment and relocation cost of new manager.

Should the provision for restructuring be made net of expected gain on disposal of assets at units?

Response

Paragraph 80 of Ind AS 37 provides “A restructuring provision shall 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.”

Paragraph 81 of Ind AS 37 provides “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 are recognised on the same basis as if they arose independently of a restructuring."

In accordance with the above, cost of employee termination is an expenditure, which is necessarily entailed by restructuring. Therefore, it should be included in restructuring provision.

Staff training cost and recruitment cost and cost of new manager relates to future conduct of business, therefore should not be included.

Further, paragraph 83 clarifies that any gain on expected disposal of assets should not be taken into consideration while determining the cost of provision. Accordingly, provision for restructuring should not be made net of any expected gain on disposal of assets at units.

Contingent Assets

Question 21

When should an entity disclose a contingent asset?

Response

As per paragraph 89 of Ind AS 37, "Where an inflow of economic benefits is probable, an entity shall 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 paragraphs 36-52." Thus, disclosure of contingent asset is required when the inflow of economic benefits is probable. This can be summarised as follows:

Particulars	Treatment under Ind AS 37
An inflow of economic benefits is not probable	No description required in financial statements
An inflow of economic benefits is probable	Disclose as contingent asset
An inflow of economic benefits is virtually certain	Recognise as an asset

For example, an entity has filed a legal case on its supplier for liquidated damages of Rs. 3 million. The supplier has disagreed with the claim and is unwilling to make settlements outside court. In this case an inflow of economic benefits is not probable.

Subsequently, the court ruled a judgment in favour of the entity. However, the supplier has filed an appeal against the court order. Management of the entity is of the opinion that again the court order will be in its favour. In this case, it will be appropriate to disclose this amount as contingent asset as the inflow of economic benefits is probable.

Recognition of asset in the books will be appropriate when the final decision in the favour of entity is received and there is virtual certainty of inflow of economic benefits.

Levies

Question 22

The annual reporting period of ABC Ltd. ends on March 31. As per the legislation of the State Government, a levy is imposed on ABC Ltd. in full when it generates revenue in Financial Year 2016-17. The levy imposed by the Government is calculated by reference to revenue generated by ABC Ltd. in previous financial year. ABC Ltd. had generated revenue of Rs. 200 crore in Financial Year 2015-16. For Financial Year 2016-17, it starts to generate revenue on April 5, 2016. ABC Ltd. paid the levy on July 10, 2016. What is the obligating event that gives rise to the recognition of a liability to pay a levy in the present case? What are the principles for recognising the levy in the annual financial statements and interim financial report?

Response:

Paragraph 4 of Appendix C to Ind AS 37 *inter alia* states that, a levy is an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (i.e. laws and/or regulations), other than:

(a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of Ind AS 12, *Income Taxes*); and

(b) fines or other penalties that are imposed for breaches of the legislation

According to paragraph 10 of Ind AS 37, 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.

As per paragraph 8 of Appendix C to Ind AS 37, the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. For example, 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 generated in previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous is necessary, but not sufficient, to create a present obligation.

In accordance with the above principles, the liability in the given case should be recognised in full on April 5, 2016 because the obligating event is the first generation of revenue in 2016-17. The generation of revenue in 2015-16 is necessary, but not sufficient, to create a present obligation. In other words, the activity that triggers the payment of the levy, as identified by the legislation, is the point at which ABC Ltd. first generates revenue in 2016-17. The amount of revenue generates in previous year (2015-16) is only relevant for the measurement of the liability. Further, the date on which the levy is paid does not affect the timing of recognition of the liability to pay a levy, because the obligating event is the activity that triggers the payment of the levy (and not the payment of the levy itself).

With regard to interim financial report, paragraph 13 of Appendix C to Ind AS 37 provides that 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.

In the given case, ABC Ltd. has a present obligation to pay the levy on April 5, 2016. In the first interim financial report for the quarter ending June 30, 2016, the liability should be recognised in full since the liability is recognised in full on April 5, 2016.