Date: 18, 20 & 22 January 2021

VIRTUAL COACHING CLASSES
ORGANIZED BY BOARD OF STUDIES, ICAI

Final Level – 2nd batch May-2021 Exams
PAPER 1: FINANCIAL REPORTING

TOPIC: IND AS 19 - IND AS 37 - PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Faculty: CA. Aditya Kulkarni

Topics to be Covered

Particulars	Slides Reference		Slides Reference
Need for Ind AS 37	3	▪ Contingent Assets	47-52
Scope of Ind AS 37	4-6	Measurement Principles	
About Provisions	7-12	▪ Best Estimate	55-60
Recognition of Provisions		▪ Risks and Uncertainties	61
▪ Present Obligation	16	▪ Present Value	62-63
▪ Past Event	17-26	▪ Future Events	64-65
▪ Probable Outflow	27-28	▪ Expected Disposal of Assets	66-67
▪ Reliable Estimate of Outflow	29-30	Reimbursements	68-72
Questions on Recognition Criteria	31-39	Changes Uses of Provisions	73-75
Contingencies		Applying Measurement Principles	77-94
▪ Contingent Liabilities	41-46	Disclosures	95-96

Need for Ind AS 37

Objectives of Ind AS 37

Ensure appropriate recognition criteria and measurement bases are applied to Provisions, Contingent Liabilities and Contingent Assets

Ensure that sufficient information is disclosed in the Notes to enable users to understand nature, timing and amount of Provisions, Contingent Liabilities and Contingent Assets

Provisions – tools for creative accounting ⇨ Hence IAS 37 (IFRS) was introduced

What is covered in Ind AS 37?

Scope of Ind AS 37 (Para 1)

Applicability (Para 1)

Recognition | Measurement | Accounting

Provisions, contingent liabilities and contingent assets

⇩

Including onerous contracts

Exclusions (Para 1)

- Provisions, contingent liabilities and contingent assets resulting from executory contracts
  ⇩
  Excluding onerous contracts
- Provisions, contingent liabilities and contingent assets covered by other Standard
- Financial Instruments (including guarantees) within the scope of Ind AS 109

Example 1: Page 9.86

Position on 1 April 20X2:

On 1 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.

Position on 1 June 20X2:

By 1 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.

Position on 1 September 20X2:

By 1 September 20X2, Company XYZ Limited has produced and delivered the full 1,000 units, but Company PQR Limited has only paid for 800 units in total.

Discuss the status of the contract on the above date.

ICAI Examples

What is covered in Ind AS 37?

Overriding effect of other Ind ASs over Ind AS 37 e.g.

- Ind AS 115 'Revenue from Contracts with Customers'
- Ind AS 103 Contingent Consideration of an acquirer in a business combination
- Ind AS 12 'Income Taxes'
- Ind AS 104 'Insurance Contracts'
- Ind AS 116 'Leases'
  - Except lease that becomes onerous before the commencement date of the lease as per Ind AS 116
  - Except short-term leases and leases for which the underlying asset is of low value and that have become onerous
- Ind AS 19 'Employee Benefits'

Provisions which are adjustments to carrying amount of assets e.g. provision for depreciation/ impairment/ doubtful assets are excluded from Ind AS 37; dealt under other applicable Ind AS!

Provision

= liability of uncertain timing or amount

= 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.

Therefore, PROVISION = LIABILITY – Timing certainty OR Amount certainty

Trade payables ⇨ Goods/services received + invoiced/formally agreed with supplier ⇨ Timing & amount known

Accruals ⇨ Goods/services received + not invoiced/formally agreed with supplier ⇨ Timing/amount virtually known

⇨ Includes amounts due to employees (e.g. amounts relating to accrued vacation pay)

Not provisions

Example: Page 9.91

Nature of Obligation	Is it provision under Ind AS 37?	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.

ICAI Examples

Example: Page 9.91

Nature of Obligation	Is it provision under Ind AS 37?	Reasons
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.

ICAI Examples

Provision

= liability of uncertain timing or amount

= a present obligation of the entity arising from past events ⇨ outflow of benefits

creates

- Legal obligation
  - Contract (through explicit or implicit terms)
  - Legislation
  - Other operation of Law
- Constructive obligation
  - Based on past practice
  - Commitment

Example 2: Page 9.88

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.

What is the obligating event in the given case?

ICAI Examples

ICAI Examples

Example 3: Page 9.88-89

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.

Example 4: Page 9.89

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.

Contingent Liability / Asset

= a possible obligation of the entity that arises from past events	⇨	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
= a present obligation of the entity arising but is not recognized	⇨	It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or The amount of obligation cannot be measured with sufficient reliability
= a possible asset of the entity that arises from past events	⇨	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 5: Page 9.89

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.

Example 6: Page 9.89-90

X Ltd. filed a legal suit against a supplier of goods for compensation against damages on non–supply of contracted goods.

ICAI Examples

Recognition of Provisions

Fulfil all the conditions

Present obligation

Probable outflow

Reliable estimate

Are all conditions met

YES

Recognize a provision

NO

Disclose as a contingent liability or 'do nothing'

Present Obligation

Possible scenarios

General

It is clear that present obligation exists

Exception

Rare cases where existence of present obligation is not clear

Evaluate past event

Consider all evidence, including opinion of experts and events after reporting period

- Where it is probable i.e. more likely than not that a present obligation exists at the end of the reporting period
  - Recognise provision if recognition criteria are met
- Where it is more likely that no present obligation exists at the end of the reporting period
  - Disclose as a contingent liability or 'do nothing'

Past Event

Past Event ⇨ Leads to a present obligation ⇨ Obligating Event

Legal obligation

Constructive Obligation

Make provision for the liability that arises

No provision required for ⇨ costs that need to be incurred by an entity to operate in future

Liabilities recognised ⇨ only those that exist at the end of the reporting period

Obligations arising from past events ⇨ which are independent of entity's future actions

⇩

Recognise provisions

If future expenditure can be avoided ⇨ no present obligation for that expenditure exists

⇩

Do not recognise provisions

Illustration 1: Page 9.93 [NEWLY ADDED]

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.

ICAI Illustrations

Example 7: Page 9.94

What would be the past event in the following cases?

1. In respect of warranty provision;
2. In respect of contamination of land;
3. In respect of Provision for dismantling or cleaning the oil rig

Examples 8 & 9: Page 9.94

1. 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.
2. 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.

Example 10: Page 9.95

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.

ICAI Examples

Example 11: Page 9.95

Staff retraining as a result of changes in 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.

Example 12: Page 9.95

Legal requirement to fit smoke filters

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

Example 13: Page 9.96

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. Refer Ind AS 16 for guidance.

ICAI Examples

Example 14: Page 9.96

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.

Example 15: Page 9.96

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.

ICAI Examples

Illustration 2: Page 9.97

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. Is the accounting policy of X Shipping Ltd. correct?

ICAI Illustrations

Past Event

Obligations arising from past events ⇨ Not necessary to know identity of the party to whom obligation is owed

New legislation ⇨ Obligation would arise only when legislation is virtually certain to be enacted as drafted ⇨ Legal Obligation

Example 17: Page 9.98

Contaminated land – legislation virtually certain to be enacted

An entity in the oil industry (having 31 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 March 31, 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.

Example 18: Page 9.98

Contaminated land and constructive obligation

An entity in the oil industry (having 31 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.

ICAI Examples

Example 19: Page 9.98-99

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.

Example 20: Page 9.99

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 31 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 31 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.

ICAI Examples

Illustration 3: Page 9.99-100

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?

ICAI Illustrations

Probable Outflow

Possible scenarios

Outflow is probable if the event is more likely than not to occur i.e. probability that event will occur > probability that it will not

Probability > 50%

Recognise provision

If it is not probable that a present obligation exists

Probability < 50%

Disclose contingent liability

If outflow of resources is remote, 'do nothing'

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 21: Page 9.100

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.

Example 22: Page 9.101

Refunds policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known. It is assumed that a reliable estimate can be made of any outflows expected.

ICAI Examples

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.
- 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.

Illustration 4: Page 9.101

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. In the financial statements for 20X1-20X2, should X Ltd. provide for both base commission and additional commission?

ICAI Illustrations

Page 9.126

Question 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 more than 50% chance of winning the appeal. Please advise how the company should account for these transactions in the financial year 20X1-20X2.

ICAI Test Your Knowledge

Page 9.126

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

Page 9.126

Question 3

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?

ICAI Test Your Knowledge

Page 35

FAQ 34: Impact of Government Order

In order to encourage companies and organisations to generously contribute to the Government's COVID-19 relief fund, taxation laws have been amended to reckon these contributions as deductible for the current financial year i.e. year ending March 31, 2020 even if the contributions are made after the year end but within three months after year end. Similarly, such contributions to COVID-19 funds are considered for compliance with annual spends on corporate social responsibility (CSR) for the current accounting year under the Companies Act, 2013. In this scenario, whether the contributions to COVID-19 Relief Funds made subsequent to reporting date of the current accounting period can be provided for as expenses of the current accounting period? Also show its impact on deferred tax, if any.

ICAI COVID-19 FAQ

Recognition Criteria for Provisions - Illustrated

Question 1:

Kshitij Ltd. was under audit for the year ended 31 March, 2020. An appeal filed by Kshitij Ltd. against a GST demand of ₹ 30 crores was pending before the Supreme Court for which neither a provision was made nor was disclosed in the Notes to the Financial Statements. On 14 July, 2020 (i.e. subsequent to the balance sheet date), the Auditor came to know that the point involved in the appeal of Kshitij Ltd. was adjudicated by the Supreme Court in the case of another taxpayer in favour of the GST Department. The auditor insisted that provision be made of ₹ 30 crores in the financial statements. The management was of the view that since its own case is pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the company as at the reporting date. Is the management's view correct?

Question 2:

B&S Ltd. received a show cause notice in December, 2019 from the VAT Department intending to levy a sum of ₹ 20 lakhs. The company replied to the above notice in January, 2020 contending that it is not liable for the proposed levy. No further action was initiated by the VAT Department up to the finalization of the audit for the year ended on 31 March, 2020. As the auditor of the company, how would you deal with this matter in your report?

Recognition Criteria for Provisions - Illustrated

Question 3:

Fin Books Ltd. is a company engaged in consultancy. It has been regular in depositing its taxes, and as such, there is no liability of Income Tax etc. for F.Y. 2019-20. The figures for the year are as under:

Income chargeable to Tax = ₹ 211.64 lakhs

Total Income after Adjustment = ₹ 228.48 lakhs

Tax thereon = ₹ 74.13 lakhs

TDS deducted during the year = ₹ 30.45 lakhs

Tax paid during the year = ₹ 43.68 lakhs

The company has prepared its Balance Sheet as per above figures. However, during the Assessment Proceedings held before the finalization of the Balance Sheet, the Assessing Officer has issued demand of ₹ 7.52 lakhs, insisting that this amount of TDS is not reflected in Form 26AS of the Company, and thus not eligible to be claimed as credit.

The company has in reply to the same filed a Rectification with the Assessing Officer. The company is trying to contact its customers, but is unable to contact XY Ltd. which has deducted TDS of ₹ 2.39 lakhs. The rectification is pending before the Assessing officer. Suggest the treatment of ₹ 2.39 lakhs and ₹ 7.52 lakhs in the Balance Sheet.

Recognition Criteria for Provisions - Illustrated

Question 4:

RK Ltd. was involved in wage negotiations with trade unions of its organization as on 31 March, 2020. Wage revision proposals could be finalised only after obtaining final approval from the Head Office of the Company located at Delhi. The final approval was granted on 9 April, 2020 w.e.f. 1 April, 2018. The settlement covered the period from 1 April, 2018 to 31 March, 2020. The liability up to 31 March, 2020 was disclosed on account of the above settlement in the Notes forming part of the Accounts. As an auditor, advise whether such disclosure is proper.

Question 5:

A Public Interest Litigation (PIL) has been filed before the Supreme Court on the environmental influences of air, noise and water pollution, caused by certain manufacturing industries. The matter has been heard by the Court and proceedings show that the Court will direct such industries to install suitable pollution control equipment. However, till the date the accounts have been approved by the Board of Directors of a Company, no such order has come from the Court. The Company feels that no provisioning or disclosure is required as the Court order has not been served on the company. Is this justifiable?

Recognition Criteria for Provisions - Illustrated

Question 6:

Raj Ltd. had announced a Voluntary Retirement Scheme (VRS) for its employees on 1 January, 2020. The scheme is scheduled to close on 30 June, 2020. The scheme envisaged an initial lumpsum payment of maximum of ₹ 2 lakhs and monthly payments over the balance period of service of employees coming under the plan. 200 employees opted for the scheme as on 31 March, 2020. The total lumpsum payment for these employees would be ₹ 250 lakhs and the aggregate of future payments to them would amount to ₹ 1,500 lakhs.

However, no payment has been made to the employees under the scheme up to 31 March, 2020. The company has also not made any provision in its accounts towards any liability under the scheme. Give your views on the above.

Question 7:

Insights Ltd. has been assessed to Income-tax, in which a demand of ₹ 10 lakhs has been made. The company has gone in appeal. The company has deposited ₹ 6 lakhs against the demand on being pursued by the Department. The company has been advised by its counsel that there is 80% chance of losing in respect of one of the grounds which may end up confirming the demand of ₹ 4 lakhs, while on the other ground, there is fair chance of winning the appeal. How the company should treat the same while preparing final accounts?

Recognition Criteria for Provisions - Illustrated

Question 8:

Sigma Ltd. has entered into a Sale Contract of ₹ 5 crores with X Ltd. during 2019-20. The profit on this transaction is ₹ 1 crore. The delivery of goods is to take place during the first month of 2020-21. In case of failure of Sigma Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sigma Ltd. planned to manufacture the goods during the last month of 2019-20. As on Reporting Date 31.3.2020, the goods were not manufactured and it was unlikely that Sigma Ltd. will be in a position to meet the contractual obligation.

(i) Should Sigma Ltd. provide for Contingency as per Ind AS 37?

(ii) Should provisions be measured as the excess of compensation to be paid over the profit?

Question 9:

Ajax Ltd. entered into a binding contract with Ikea Ltd. to buy a machine for ₹ 5,00,000. The machine is to be delivered on 15 March, 2020. On 1 February, 2020, Ajax changed its production process. The new process will not require the machine ordered and it shall have to be scrapped after delivery. The expected scrap value of the machine in NIL. Explain how Ajax Ltd. should recognise the entire transaction for the year ended 31 March, 2020.

Recognition Criteria for Provisions - Illustrated

Question 10:

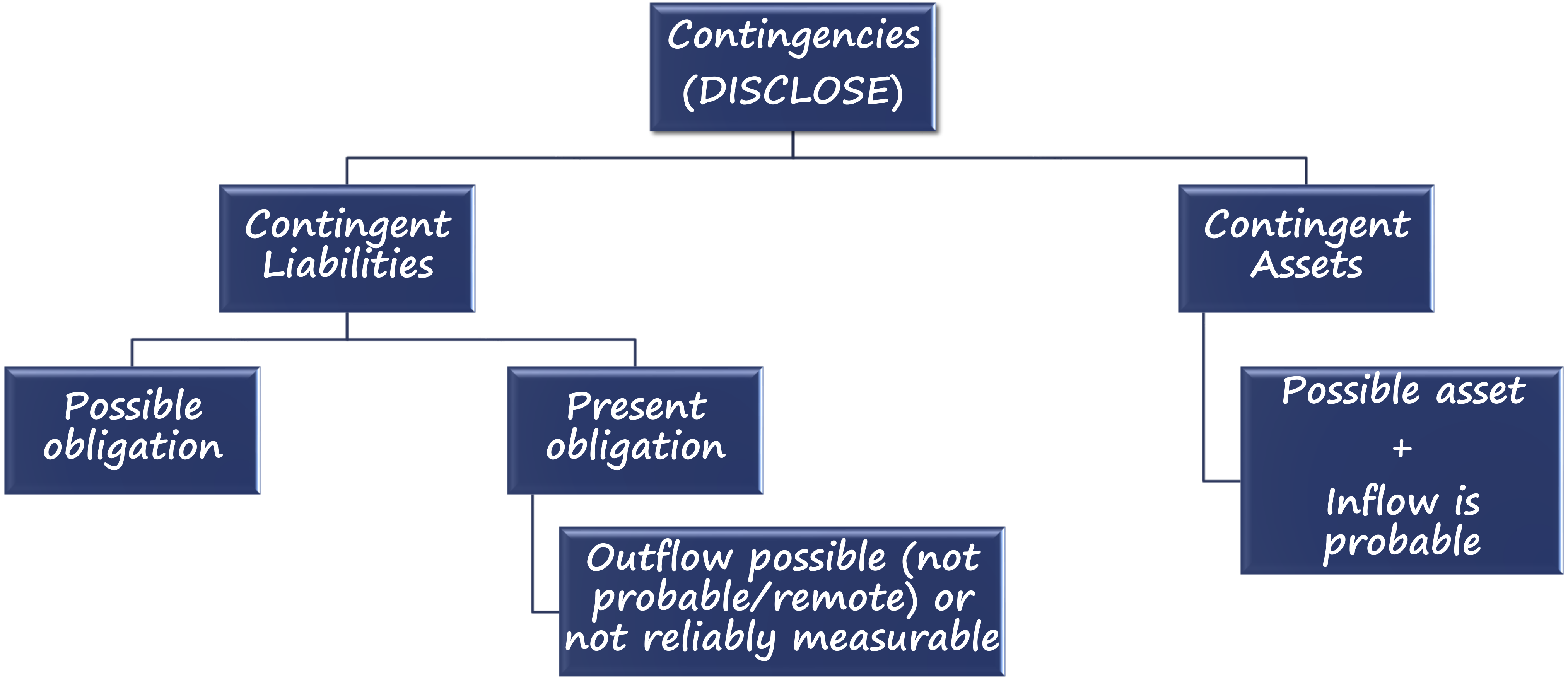
Rajaram Ltd. had a major breakdown in its plant in February, 2020. In March, 2020, it entered into an agreement with an Engineering Firm for the purpose of repairing its plant for a consideration of ₹ 180 lakhs. The Engineering Firm started the repairs in April, 2020 and completed the work in the same month. The company made a provision for the said expenditure on repairs in its books for the year 2019-20 on the ground that the event of breakdown leading to repairs had taken place in 2019-20, binding contract was entered into during 2019-20 and repair was completed before the Financial Statements were approved by the Company's Board of Directors. Comment.

Question 11:

A company gives a cash discount to its customers for prompt payment of dues. During March 2021, sales are made in respect of which cash is expected to be recovered in April, 2021, which will entitle the customers to a rebate. The company opines that it should make a provision for the expected liability arising on account of the cash discount. The company believes that from a matching concept, the expenses towards the cash discount should be matched with the sales revenue.

Should the company make the provision for expected liability on account of cash discount?

Contingencies



Contingent Liabilities

- 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.
- 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).

Page 9.103

Tabular Summarisation

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.

Summary

Contingent Liabilities - Illustrated

Question 12:
The indirect tax authorities have carried out a survey at X Hotels Ltd. in February, 2020. The authorities claimed that they have certain evidence in their possession which points to understatement of income by X Hotels Ltd. The survey proceedings were completed in March, 2020. The company learnt informally that the authorities would be raising a demand in that regard, although the amount of the demand could not be reliably estimated. How should the company account for this event in its financial statements?

Question 13:
X Ltd. is a leading computer hardware manufacturer. Just prior to the close of the financial year, it received a notice of patent infringement from one of its competitors, Y Ltd. The notice mentions that X Ltd. has copied critical features of some of Y Ltd.'s products. The management of X Ltd. discussed the case with its legal counsel. The legal counsel was of the view that based on the available facts, the notice was legally tenable, however, there was not enough information to estimate the potential loss. How should the situation be dealt with in the books of X Ltd.?

Contingent Liabilities - Illustrated

Question 14:
A company is in a dispute involving allegation of infringement of patents by a competitor company who is seeking damages of ₹ 15 crores. The directors are of the opinion that the claim can be successfully resisted by the company. How would you deal with this in the annual accounts of the company?

Question 15:
MX Ltd. files a lawsuit against DX Ltd. for ₹ 7 crores. The attorney of DX Ltd. feels that the suit is without merit, so DX Ltd. merely discloses the existence of the lawsuit in the Notes accompanying its Financial Statements. As the auditor of DX Ltd., how will you deal with the situation?

Question 16:
Included under Sundry Creditors was Fees Payable to Legal Counsel for suits filed against the Company. The Company is not aware of the status of the suits and hence, did not want to provide for claims under the same. Describe your views on the above.

Contingent Liabilities - Illustrated

Question 17:

A company has, at its financial year ending 31 March, 2020, 15 lawsuits outstanding, none of which have been settled by the time the accounts are approved by the Directors. The Directors have estimated that the possible outcomes are as below:

Results	For first ten cases		For remaining five cases	
	Probability	Amount of loss	Probability	Amount of loss
Win	0.6	Nil	0.5	Nil
Lose – low damages	0.3	₹ 9,00,000	0.3	₹ 6,00,000
Lose – high damages	0.1	₹ 16,00,000	0.2	₹ 9,50,000

The directors believe that the outcome of each case is independent of the outcome of all of the others. Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.

Contingent Liabilities - Illustrated

Question 18:

Pioneers Ltd. had been served a claim for damages of ₹ 75 lakhs in January, 2020 for breach of Patents and Copyrights. The Directors sought competent legal advice on the eligibility of the claim and were advised that the claim was highly frivolous, without any basis and would not survive even in the first Trial Court. The Company, however, anticipates a long drawn legal battle and huge legal costs. How would this issue be treated in the accounts for the year ended 31 March, 2020?

Contingent Assets

- 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.

Page 9.104 **Tabular Summarisation**		
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 for the contingent asset.	No disclosure is required.

ICAI Summary

Example 2: Page 9.89-90

X Ltd. filed a legal suit against a supplier of goods for compensation against damages on non–supply of contracted goods.

Page 9.104

Illustration 5

X Sugars Ltd. has entered into a sale contract of ₹ 3,00,00,000 with Y Chocolates Ltd. for the supply of sugar during 20X1-20X2. As per the contract the delivery is to be made within 2 months from the date of contract. In case of failure to deliver within the schedule, X Sugars Ltd. has to pay a compensation of ₹ 30,00,000 to Y Chocolates Ltd.

During the transit, the vehicle carrying the sugar met accident and X Sugar Ltd. lost the entire consignment. It is, however covered by an insurance policy. According to the report of the surveyor, the amount is collectible, subject to the deductible clause [i.e., 15% of the claim] in the insurance policy. The cost of goods lost was ₹ 2,50,00,000.

Before the financial year end, X Sugars Ltd. received informal information from the insurance company that their claim had been processed and the payment had been dispatched for 85% of the claim amount. Meanwhile Y Chocolates Ltd. has made demand of ₹ 30,00,000 since goods were not delivered on time.

ICAI Illustrations

Contingent Assets - Illustrated

Question 19:

During the year, QC Ltd. delivered manufactured products to Customer A. The products were faulty and on 1 October, 2019, Customer A initiated legal action against the company claiming damages in respect of losses due to supply of faulty product. Upon investigating the matter, QC Ltd. discovered that the products were faulty due to defective raw material procured from Supplier D. Therefore, on 1 December, 2019, the company initiated legal action against D claiming damages in respect of supply of defective raw materials. QC Ltd. has estimated that the probability of success of both legal actions, the action of A against QC Ltd. and action of QC Ltd. against D, is very high. On 1 October, 2019, QC Ltd. has estimated that the damages it would have to pay A would be ₹ 5 crores. This estimate was revised to ₹ 5.2 crores on 31 March, 2020 and to ₹ 5.25 crores on 15 May, 2020. This case was eventually settled on 1 June, 2020, when QC Ltd. paid damages of ₹ 5.3 crores to D.

On 1 December, 2019, QC Ltd. had estimated that it would receive damages of ₹ 3.5 crores from D. This estimate was revised to ₹ 3.6 crores as at 31 March, 2020 and ₹ 3.7 crores as on 15 May, 2020. This case was eventually settled on 1 June, 2020 when F paid ₹ 3.75 crores to QC Ltd. QC Ltd. had, in its financial statements for the year ended 31 March, 2020 provided ₹ 3.6 crores as the financial statements were approved by the Board of Directors on 26 April, 2020.

Contingent Assets - Illustrated

Question 19 (continued):

1. Whether the company is required to make provision for the claim from Customer A as per applicable Ind AS? If yes, please give the rationale for the same.
2. If the answer to (a) above is yes, what is the entry to be passed in the books of account as on 31 March, 2020? Give brief reasoning for your choice.
3. What will be the accounting treatment of the action of QC Ltd. against supplier D as per applicable Ind AS?

RTP: May 2020

Question 3

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 April 20, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition. Duty drawback has been credited by the Department on June 28, 20X2 and financial statements have been approved by the Board of Directors of the company on July 26, 20X2. What would be the treatment of duty drawback credit as per the given information?

ICAI RTP

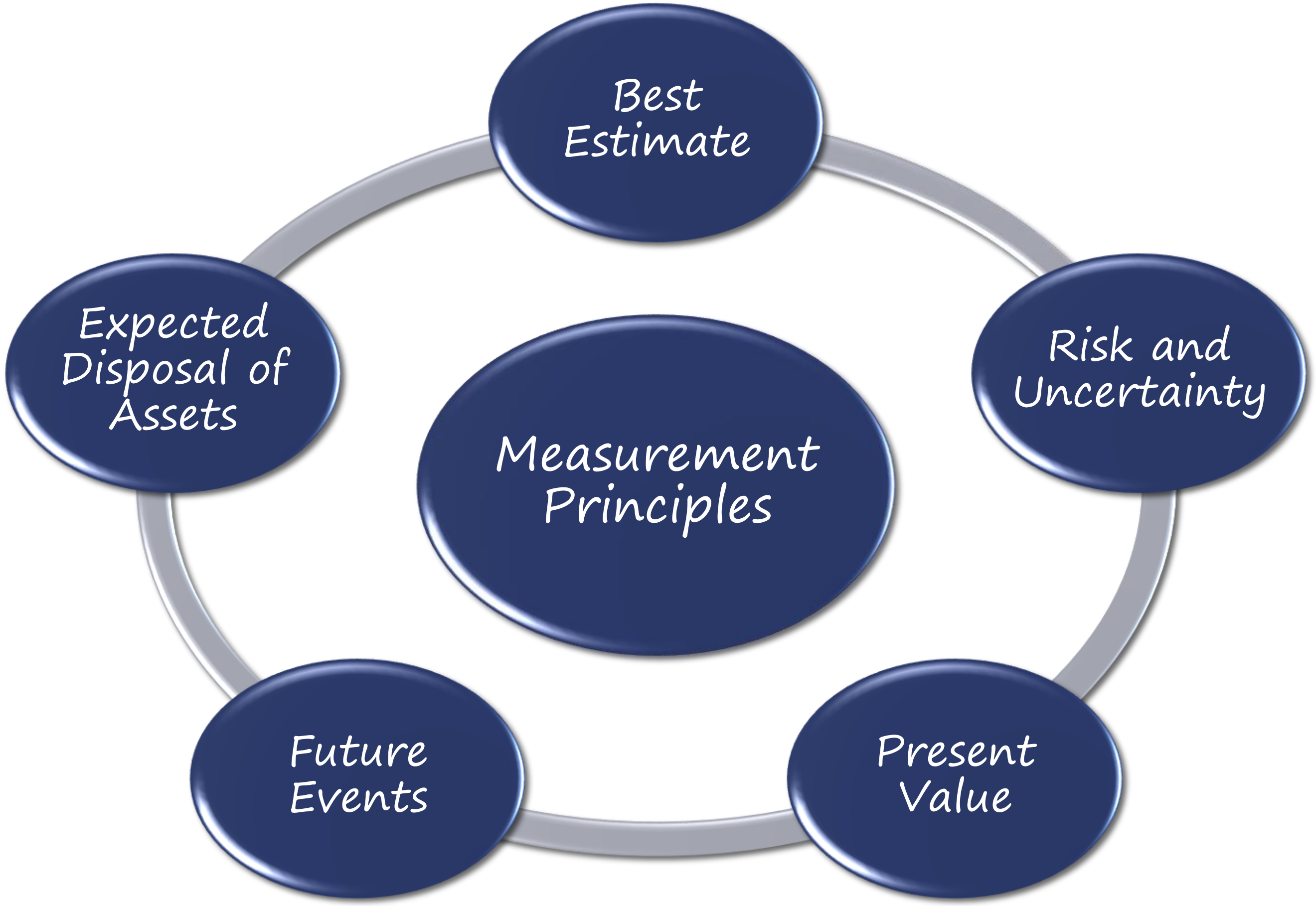
Page 9.104

Tabular Summarisation

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

Summary

Measurement



Measurement Principles: Best Estimate

Amount of Provision = best estimate of the expenditure required to settle the present obligation at the end of the reporting period

Best estimate = estimate of amount that an entity would rationally pay to settle or transfer the obligation

Determination of estimate = judgment of management/similar past experiences/report from experts/including evidence after reporting period

Uncertainties dealt as per circumstances

Provisions measured should be before tax – tax effect covered under Ind AS 12

Large population of items e.g. customer refunds or warranties	Continuous range of outcomes	Single obligation
Expected value = weighting all possible outcomes by associate probabilities	Each point is as likely as other => mid-point of the range is used	Individual most likely outcome. Consider other possible outcomes also

Page 9.106

Illustration 6

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. In accordance with the standard, an entity assesses the probability of an outflow for the warranty obligations as a whole.

ICAI Illustrations

Example 23: Page 9.106

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.

Examples 24 & 25: Page 9.106

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 (say), but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

Example 26: Page 9.107

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.

ICAI Examples

RTP: November 2019

a) 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 remedy, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. As this is the first year that the warranty has been available, there is no data from the firm to indicate whether there will be claim under the warranties. However, industry research suggests that it is likely that such claims will be forthcoming.

Should the manufacturer recognize a provision in accordance with the requirements of Ind AS 37? Why or why not?

b) Assume that the firm has not been operating its warranty for five years, and reliable data exists to suggest the following:

- If minor defects occur in all products sold, costs of ₹ 20,00,000 would result.
- If major defects occur in all products, costs of ₹ 50,00,000 would result.
- The manufacturer's past experience and future expectations indicate that each year 80% of goods sold will have no defects. 15% of goods sold will have minor defects, and 5% of goods sold will have major defects.

Calculate the expected value of the cost of repairs in accordance with the requirements of Ind AS 37, if any. Ignore both income tax and the effect of discounting.

ICAI RTP

Measurement Principles - Illustrated

Question 20:

A company provides after-sales warranty for 2 years to its customers. Based on the past experience, the company has the following policy for making Provision for Warranties on the invoice amount, on the remaining balance warranty period:

Less than 1 year: 2% provision

More than 1 year: 3% provision

The company has raised invoices as under:

Invoice Date	Amount (₹)
19 January 2018	4,00,000
29 January 2019	2,50,000
15 October 2019	9,00,000

Calculate the provision to be made for Warranty under Ind AS 37 as at 31.3.2019 and 31.3.2020. Also compute the amount to be debited to the Statement of Profit and Loss for the year ended 31.3.2020.

Measurement Principles - Illustrated

Question 21:

Blitz Ltd. sold 1 lakh Gaming Stations during the year with a warranty condition to make good by repair/replacement any manufacturing defects reported within six months from the date of sale. Past experience in this regard showed that there were no replacements carried out but minor/major repairs were necessitated to the extent of 10%/5% respectively of the units sold. The cost of such minor/major repairs would amount to ₹ 1,000/₹ 6,000 per unit respectively. While finalizing the accounts for the year, the company does not reflect any provision in this regard. Comment.

Measurement Principles: Risks and Uncertainties

⇩

Consider all risks (i.e. variability of outcome) and uncertainties to arrive at best estimate of a provision

⇩

Make risk adjustment for amounts due in excess of expected present value of outflows due to uncertainty

⇩

Exercise caution in risk adjustment => do not overstate incomes/assets, understate expenses/liabilities

⇩

Making risk adjustment for uncertainty does not mean making excessive provisions or overstating liabilities

⇩

Disclose uncertainties around the best estimate of expenditure

3-pronged approach of risk adjustment →
- Add to expected present value of future outflows
- Adjusting the estimates of future outflows
- Adjusting the discount rates

Measurement Principles: Present Value

Effect of time value of money is material

Provisions to be made at present value of expenditures required to settle the obligation

Expected present value of outflows = PV of each outcome weighted by associated probabilities

Use pre-tax discount rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

Discount rate should not reflect risks for which future cash flows have been adjusted (double adjustment)

Illustration 7: Page 9.108

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. How should X Solar Power Ltd. account for the obligation?

Illustration 8: Page 9.108

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. The time value of money is considered to be material.

Calculate the amount to be provided for at 31st March 20X1 for the costs of restoring the seabed.

ICAI Illustrations

Measurement Principles: Future Events

⇩

Future events affect amount required to settle an obligation => reflect in the provision amount

⇩

e.g. changes in technology may reduce the cost of cleaning up a site at the end of its life

⇩

Sufficient objective evidence should be obtained

⇩

Reasonable expectations should be made

⇩

e.g. effect of new legislations can be considered only when evidence of virtual certainty of enactment is available, which is rare

Illustration 9: Page 9.110

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 March 31, 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. How should X Chemicals Ltd. deal with this situation?

ICAI Illustrations

Measurement Principles: Expected Disposal of Assets

Gains on expected disposal of assets should not be considered while measuring provision

⇩

Even if expected disposal is closely linked to the event giving rise to a provision

⇩

Recognise gain on expected disposal at the time specified by the applicable Standards

Example 27: Page 9.110

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

ICAI Examples

Reimbursements

General Principle: Recognition

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party

Recognise only if virtually certain that the reimbursement will be received if the obligation is settled

Treat reimbursement as a separate asset – no offsetting against provision

Expense relating to provision may be offset against reimbursement

Reimbursement ≤ Provision

Generally: recognise provision for full amount and a separate asset for reimbursement

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!!

Page 9.111-112

Tabular Summarisation

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

Summary

Illustration 10: Page 9.112

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, a claim of ₹ 30,00,000 becomes payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?

ICAI Illustrations

Page 34

FAQ 33: Recognition of Asset for Insurance Claim Recovery

A reputed event and conference management company had obtained loss of profits insurance cover to mitigate the risk of potential business losses due to circumstances beyond its control. During the current accounting year, it has estimated a loss of profit of certain amount and initiated its discussion with the insurance company for reimbursement of the loss. The entity is confident that the insurance company will admit and honour its claims for loss of profits. Accordingly, the entity is considering recognising an asset for this insurance claim recovery. Is this accounting acceptable under Ind AS?

ICAI COVID-19 FAQ

Reimbursements - Illustrated

Question 22:

Akshara Ltd. is a public sector company providing Consultancy services to clients. In 2019-20, the Government set up a Commission to decide about the pay revision. The pay will be revised with effect from 1 January, 2018 based on the recommendations of the Commission. The company makes a provision of ₹ 1,250 lakhs for pay revision in the Financial Year 2019-20 on an estimated basis as the final report of the Commission is not yet received. As per the contracts with clients having a cost-plus billing model, the billing is done on the actual payment made to the Employees and allocated to jobs based on the hours booked by these employees on each job. In the Notes to Accounts, the company discloses the following:

"Salaries and Benefits include Provision of ₹ 1,250 lakhs in respect of Pay Revision. The amount chargeable from Reimbursable Jobs will be billed as per the contract when the actual payment is made."

The accountant feels that the company should also recognize/book the income of ₹ 1,250 lakhs in the Statement of Profit and Loss as per the terms of the contract, failing which it would amount to violation of matching concept and understatement of profits.

Comment on the opinion of the accountant with reference to Ind AS 37.

Changes in Provisions and Use of Provisions

General Principle: Change in Provisions

Review provisions at the end of each reporting period and adjust to reflect the current best estimate.

If no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation

Reverse the provision

Where discounting is used, carrying amount of provision increases to reflect passage of time

Increase is recognised as borrowing cost

Use of Provisions: only for expenditures for which provision was originally recognised

Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Example 28: Page 9.112

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.

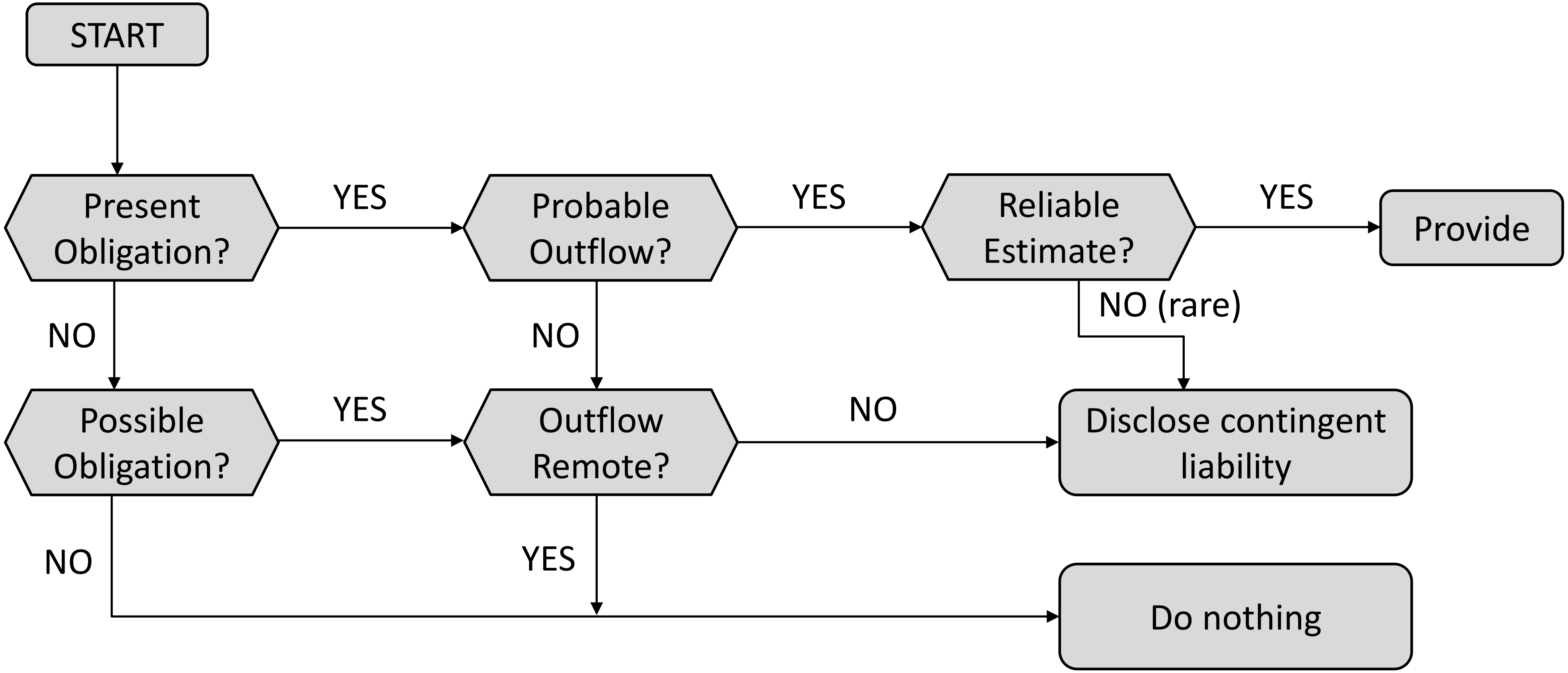
ICAI Examples

Illustration 11: Page 9.112-113

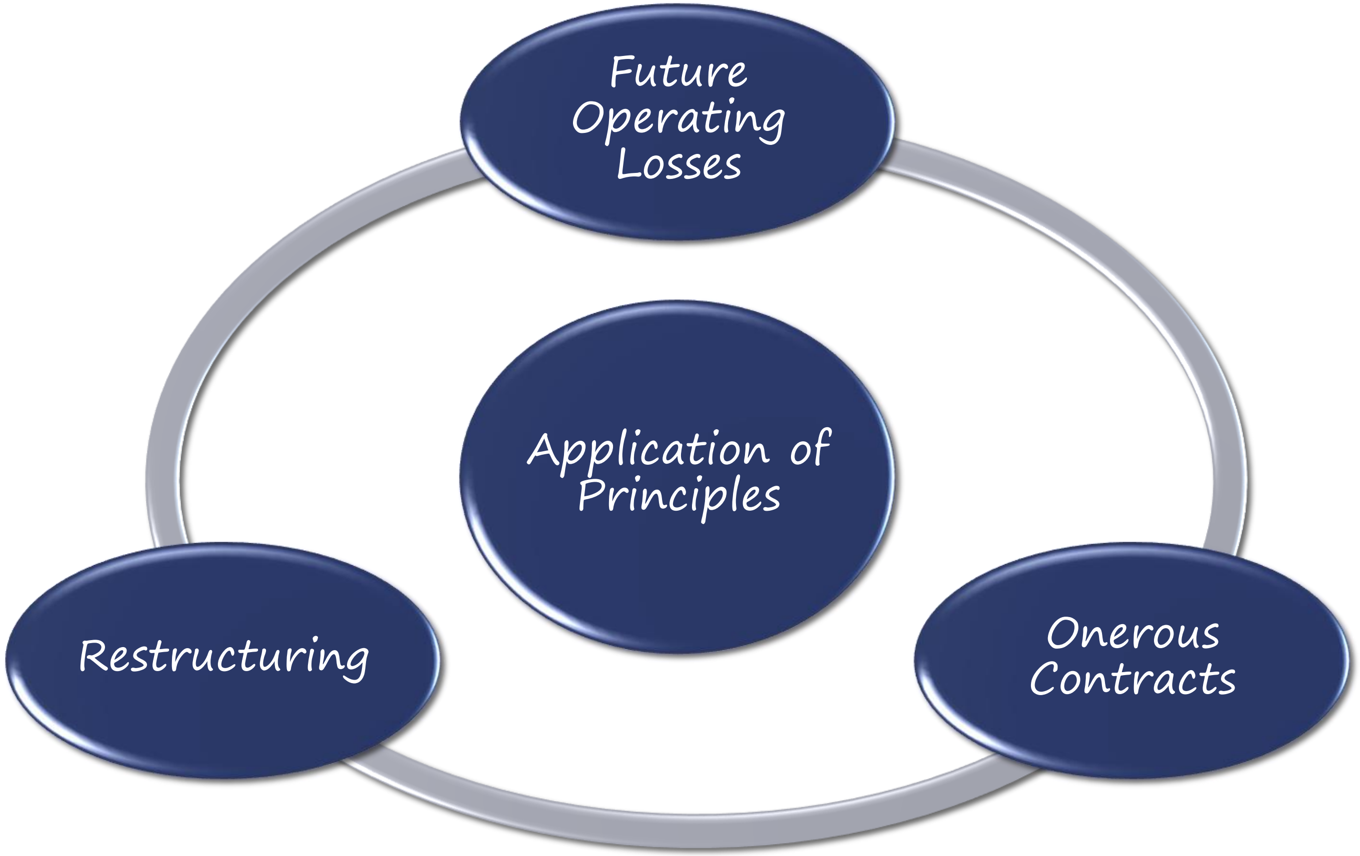
X Telecom Ltd. has income tax litigation pending before appellate authorities. Legal advisor's opinion is that X Telecom Ltd. will lose the case and estimated that liability of ₹ 1,00,00,000 may arise in two years. The liability is recognised on a discounted basis. The discount rate at which the liability 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 borrowing cost?

ICAI Illustrations

DECISION TREE



Application of Recognition and Measurement Principles



Future Operating Losses

Accounting Principle

Do not recognise provision 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

Recognition of provision for future operating losses is not allowed since they do not stem from a past event

Future operating losses are an indication that certain assets may be impaired in terms of the indicators specified in Ind AS 36

Test the assets for impairment under Ind AS 36, Impairment

Page 9.114

Illustration 12

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 April 1, 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 March 31, 20X1. Can X Packaging Ltd. include these operating losses in a provision for restructuring?

ICAI Illustrations

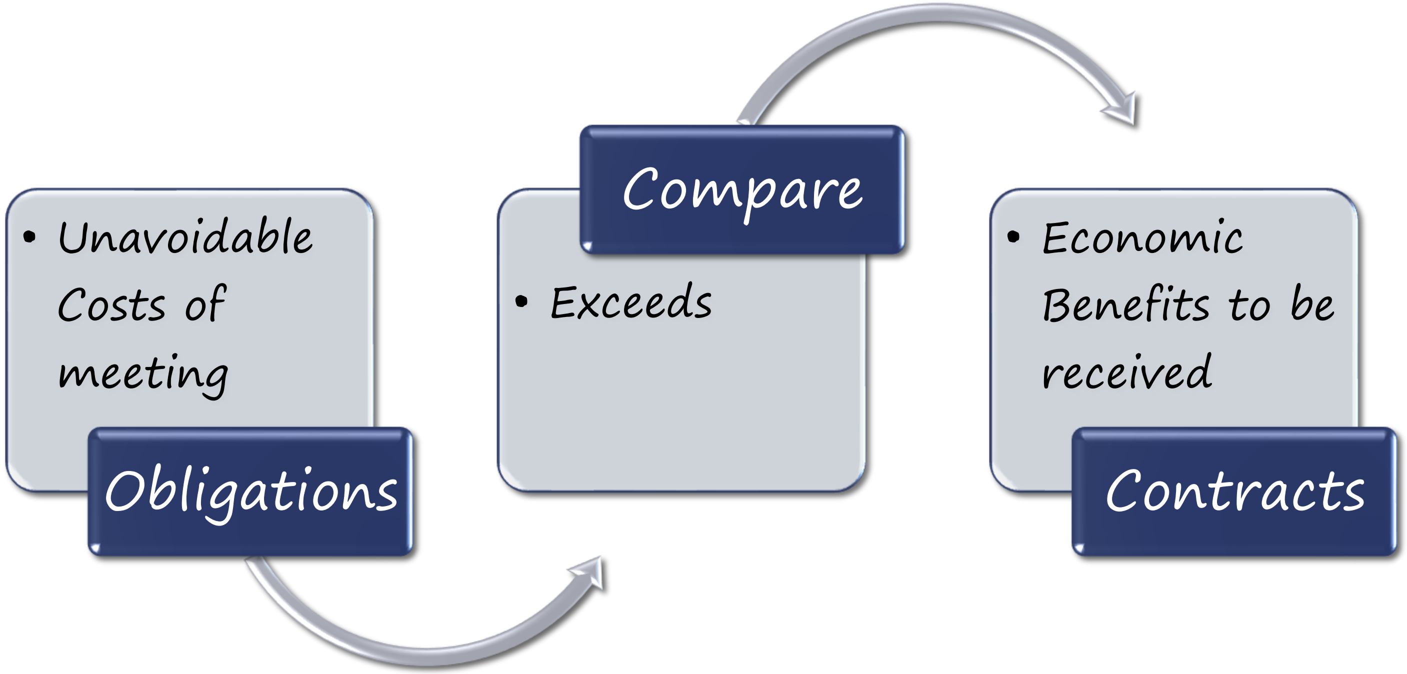
Page 33-34

FAQ 32: Provision for Future Operating Losses

An entity engaged in tourism and hospitality is heavily dependent upon the tourists from India travelling overseas and foreign nationals visiting India. In the light of COVID-19 outbreak across the globe, the entity has analysed the likely impact of customers behaviour coupled with bleak employment scenario on its revenue over the next one year. This review has indicated possible substantial operating losses during the next financial year i.e. 2020-21. The entity is exploring the possibility of recognising certain amount of operating losses as provision in the financial statements of the current year itself i.e. 2019-20. Is this accounting permitted under Ind AS?

ICAI COVID-19 FAQ

Onerous Contracts



Onerous Contract: a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Unavoidable costs = least net cost of exiting from the contract i.e. lower of (a) fulfilling the contract and (b) any compensation or penalties arising from failure to fulfil it.

Onerous Contracts

Accounting Principle

⇩

For an onerous contract, the present obligation under the contract should be recognised and measured as a provision.

⇩

Before establishing provision for onerous contract, recognise any impairment loss on assets dedicated to the contract as per Ind AS 36

Imp: Executory contracts which are not onerous are outside the scope of Ind AS 37!!

Examples 29-32: Page 9.115

29. 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.

30. 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.

31. 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.

32. In the year ended 31 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?

ICAI Examples

Illustration 13: Page 9.116

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.

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

ICAI Illustrations

RTP: May 2020

Question 6

Entity XYZ entered into a contract to supply 1,000 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. Is the contract onerous and how much provision in this regard is required?

ICAI RTP

Restructuring

A program planned and controlled by the Management which materially changes either (a) scope of a business undertaken by an entity, or (b) manner in which that business is conducted

Examples of Restructuring

- Sale or Termination of a line of Business
- the closure of business locations in a country or region or the relocation of business activities from one country or region to another
- changes in management structure, for example, eliminating a layer of management
- fundamental reorganisations having material effect on the nature and focus of the entity's operations

Recognise Provision for Restructuring Costs only when Recognition Criteria for provisions are met

Restructuring: Obligation

Binding Sale agreement must exist for obligation for sale of an operation

⇩

Constructive Obligation to restructure arises only when an entity:

1. Has a detailed formal plan for the restructuring identifying at least – (a) The business or part of a business concerned, (b) The principal locations affected, (c) The location, function and number of employees who will be compensated for terminating their services, (d) The expenditure that will be undertaken (e) When the plan will be implemented	AND	2. Has raised a valid expectation in those affected that it will carry out the restructuring by – (a) Starting to implement that plan, or (b) Announcing its main features to those affected by it
Evidence that an entity has started to implement a restructuring plan would be provided by dismantling Plant or selling assets or by Public Announcement of main features of the plan		Public announcement of a detailed plan creates constructive obligation if it is made in a way with sufficient detail to raise valid expectations in other parties

Restructuring: Obligation

Management Decision to restructure + implementation commencement + public announcement => all must happen before reporting date
=> Restructuring provision at the reporting date through constructive obligation

⇩

If implementation or public announcement happens after reporting period
=> non-adjusting event requiring disclosure under Ind AS 10

⇩

Implementation should be planned to begin as soon as possible for giving rise to constructive obligation. Long delays in implementation will not raise valid expectations.

Restructuring: Measurement Aspects

Provision for Restructuring costs

includes

Direct Expenditures arising from the Restructuring –

- Necessarily entailed by the restructuring AND
- Not associated with the ongoing activities of the entity

excludes

1. Costs of (a) retraining or relocating continuing staff, (b) marketing, or (c) investment in new systems or networks;
2. Identifiable future operating losses up to the date of restructuring, unless they relate to Onerous Contract
3. Set off effect of any Gains on Expected Disposal of Assets in the course of restructuring

Review assets of the operation for impairment in case restructuring involves sale of an operation

Example 33: Page 9.117

Closure of division – no implementation before end of reporting period

On March 12, 20X1 the board of an entity decided to close down a division. Before the end of the reporting period (March 31, 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.

Example 34: Page 9.117

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

On March 12, 20X1 (reporting date), the board of an entity decided to close down a division making a particular product. On March 20, 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.

ICAI Examples

Illustration 14: Page 9.119

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 January 10, 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. Do the actions of the board of directors create a constructive obligation that needs a provision for restructuring?

ICAI Illustrations

Page 33

FAQ 31: Provision for Restructuring Costs

An entity engaged in automobile sector has assessed the impact of COVID-19 outbreak on its future viability of business model. Senior Management has identified the need for restructuring some of its business activities and retrenching its employees in many areas. Senior Management is drawing up a plan for the consideration of the Board of Directors in their meeting scheduled in May 2020, which is subsequent to the reporting date of the current financial year i.e. March 31, 2020. Can the entity recognise provisions for restructuring costs in the financial statements of the current year i.e. 2019-20?

ICAI COVID-19 FAQ

Restructuring Costs - Illustrated

Question 23:

H Ltd. is a large conglomerate with multiple subsidiaries. It is preparing consolidated financial statements in accordance with the Ind AS for the year ending 31 March, 2020. The financial statements are due to be authorised for issue on 15 May, 2020. The company needs your assistance for some transactions that have taken place in some of its subsidiaries during the year.

S Ltd. is a wholly owned subsidiary of H Ltd. engaged in Management Consultancy Services. On 31 January, 2020, the Board of Directors of H Ltd. decided to discontinue the business of S Ltd. from 30 April, 2020. They made a public announcement of their decision on 15 February, 2020. S Ltd. does not have many assets or liabilities and it is estimated that the outstanding Trade Receivables and Payable would be settled by 31 May, 2020. H Ltd. would collect any amounts still owed by S Ltd.'s customers after 31 May, 2020. They have offered the employees of S Ltd. termination payment or alternative employment opportunities. On the date of public announcement, it is estimated by S Ltd. that it would have to pay ₹ 540 lakhs as Termination Payments to the Employees and the costs for relocated 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 15 May, 2020, and the total relocation cost is ₹ 60 lakhs.

Restructuring Costs – Illustrated

Question 23 (continued):

The Loss after tax of S Ltd. for the year ended 31 March, 2020 was ₹ 400 lakhs.

How should H Ltd. present the decision to discontinue the business of S Ltd. in its Consolidated Statement of Comprehensive Income as per Ind AS?

What are the provisions that the company is required to make as per Ind AS 37?

Disclosures

- Movements in provision
- Explanations for each class of provision
- Disclosures for contingent liabilities
- Aggregation of items of provisions and contingent liabilities as a class and related disclosures
- Exemption from disclosure in selected cases

Page 9.121

Illustration 15

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. The provision has not been discounted as the effect of discounting is not material. Draft the Note.

ICAI Illustrations

Levies: Appendix C of Ind AS 37

Coverage of Appendix C

Accounting for a liability to pay a levy if the liability is within scope of Ind AS 37

Accounting for a liability to pay a levy whose timing and amount is certain

i.e. deals with only credit aspect

Does not deal with accounting for costs arising from recognising a liability to pay a levy i.e. debit aspect => dealt by applicable standards to recognise cost/asset

Levy => charge imposed by governments on entities in accordance with laws and/or regulations leading to outflow of resources embodying economic benefits. Excludes following:

- Outflows of resources within the scope of other Ind AS
- Payments to government for acquiring assets/ rendering services as per contractual arrangements
- Fines or penalties imposed for breach of the legislation
- Liabilities arising from emission trading schemes

Levies: Appendix C of Ind AS 37

Accounting Principles

Obligating event => activity that triggers payment of levy, as identified by the legislation

Liability to pay levy is recognised progressively if obligating event occurs over a period of time

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 this Appendix
e.g. 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.

Entity to apply same recognition principles in interim financial report that is applied in annual financial statements

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

Example 35: Page 9.122

Closure of division – no implementation before end of reporting period

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.

ICAI Examples

THANK YOU