After studying this unit, you will be able to:

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

The objective of Ind AS 37 is to ensure that

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

2.2 SCOPE

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

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

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

(c) those covered by another Standard such as:
   (i) construction contracts (Ind AS 11, *Construction Contracts*);
   (ii) income taxes (Ind AS 12, *Income Taxes*);
   (iii) leases (Ind AS 17, *Leases*). However, as Ind AS 17 contains no specific requirements to deal with operating leases that have become onerous, Ind AS 37 applies to such cases;
   (iv) employee benefits (Ind AS 19, *Employee Benefits*); and
   (v) insurance contracts (Ind AS 104, *Insurance Contracts*). However, Ind AS 37 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.
   (vi) Contingent consideration of an acquirer in a business combination (Ind AS 103, *Business Combinations*).
2.2.1 Executory Contracts

Executory contracts are contracts under which

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

**Note:** Ind AS 37 is applied to executory contracts only if they are onerous.

**Examples of executory contracts:** Take & Pay contracts and through put contracts.

In case of take and pay contracts, an agreement is entered into between two entities wherein the purchaser is legally obligated to take delivery of goods or accept services offered by seller (and make payment for those goods or services) and if the goods or services are not taken, he is required to pay a specified amount of penalty.

In case of through put contracts, an agreement is entered into between two entities wherein one
entity undertakes to pass (put through) to another entity an agreed minimum amount of material or services during a specified period of time.

Such types of commitments, the entity has entered into are exempt from the requirements of Ind AS 37, i.e., such contracts are not covered under Ind AS 37 unless they are onerous.

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

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

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

However, Ind AS 37 does not address the recognition of revenue since there is a separate standard on it i.e. Ind AS 18, *Revenue which* identifies the circumstances in which revenue is recognized and provides practical guidance on the application of the recognition criteria.

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

**Example:** Depreciation, impairment of assets and doubtful debts.

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

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

2.3 DEFINITIONS

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

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

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

3. An **obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.
Example
X Ltd. entered into a contract with Y Ltd. for supply of some material. As per the terms of contract in case of breach of contract, the party who breaches the contract has to pay ₹50,00,000 to other party. X Ltd. breached the contract with Y Ltd. Now in this case the obligating event is the breach of contract that gave rise to present obligation and X Ltd. must settle the obligation.

4. A **legal obligation** is an obligation that derives from:
   (a) a contract (through its explicit or implicit terms);
   (b) legislation; or
   (c) other operation of law.

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

5. A **constructive obligation** is an obligation that derives from an entity’s actions where:
   (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
   (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

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

6. A contingent liability is:
   (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
   (b) a present obligation that arises from past events but is not recognised because:
(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

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

Example

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

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

Example

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

8. An **onerous contract** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

9. A **restructuring** is a programme that is planned and controlled by management, and materially changes either:

   (a) the scope of a business undertaken by an entity; or

   (b) the manner in which that business is conducted.
2.4 PROVISIONS AND OTHER LIABILITIES

Since there is uncertainty about the timing or amount of the future expenditure required in settlement of the provisions, they are different from liabilities. However, in case of liability, uncertainty is generally much less than for provisions. By contrast:

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

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

Example: Amounts relating to accrued vacation pay.

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

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

2.5 RELATIONSHIP BETWEEN PROVISIONS AND CONTINGENT LIABILITIES

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

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

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

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

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

2.6.1 Provisions

A provision should be recognised when:

(a) an entity has a **present obligation** (legal or constructive) as a result of a **past event**;

(b) it is **probable that an outflow of resources embodying economic benefits** will be required to settle the obligation; and

(c) a **reliable estimate** can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

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**2.6.1.1 Present Obligation**

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

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

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

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

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

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

### 2.6.1.2 Past Event

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

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

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

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

**Example**

1. In respect of warranty provision, it would be the original sale.
2. In respect of contamination of land, it would be the original contamination.
3. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

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

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

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

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.

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

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

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

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

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

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff has taken place. It is assumed that a reliable estimate can be made of any outflows expected.

**Present obligation as a result of a past obligating event** – There is no obligation because no obligating event (retraining) has taken place.

**Conclusion** – No provision is recognised.

Example: 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.

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

**Present obligation as a result of a past obligating event** – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.
Conclusion – No provision is recognised for the cost of fitting the smoke filters.

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

Present obligation as a result of a past obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

Example: Repairs and maintenance

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

Example: Refurbishment costs – no legislative requirement

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

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

Conclusion – No provision is recognised.

The cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the company’s future actions—even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e., it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Example: Refurbishment costs – legislative requirement

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

Present obligation as a result of a past obligating event – There is no present obligation.
Conclusion – No provision is recognised.

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in Example 14. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity’s future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e., an amount equivalent to the expected maintenance costs is depreciated over three years.

Illustration 1

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?

Solution

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

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

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

- An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed.
- A management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid
expectation in them that the entity will discharge its responsibilities.

- An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation.

Example

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

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

Example: 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.

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

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

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

Example: 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.

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

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

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

Example: Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

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

Conclusion – A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Example: 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.

(a) At 31 March 20X2

Present obligation as a result of a past obligating event – On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion – No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.
(b) At 31 March 20X3

Present obligation as a result of a past obligating event – On the basis of the evidence available, there is a present obligation.  

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

Conclusion – A provision is recognised for the best estimate of the amount to settle the obligation.

Illustration 2

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

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

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

Solution

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

2.6.1.3 Probable Outflow of Resources Embodying Economic Benefits

- For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

Note: For the purpose of Ind AS 37¹, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

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

¹ The interpretation of ‘probable’ in Ind AS 37 as ‘more likely than not’ does not necessarily apply in other Ind AS.
Example: A single guarantee

On March 31, 20X1, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 20X1-20X2, the financial condition of Entity B deteriorates and at June 30, 20X1 Entity B files for protection from its creditors.

This contract meets the definition of an insurance contract in Ind AS 104, *Insurance Contracts*, but is within the scope of Ind AS 109, *Financial Instruments*, because it also meets the definition of a financial guarantee contract in Ind AS 109. If an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either Ind AS 109 or Ind AS 104 to such financial guarantee contracts. Ind AS 104 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. Ind AS 104 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that Ind AS 104 permits and that also complies with the requirements in Ind AS 109 for financial guarantee contracts within the scope of Ind AS 109.

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

(a) **At March 31, 20X1**

*Present obligation as a result of a past obligating event* – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

*An outflow of resources embodying economic benefits in settlement* – No outflow of benefits is probable at March 31, 20X1.

**Conclusion** – The guarantee is recognised at fair value.

(b) **At March 31, 20X2**

*Present obligation as a result of a past obligating event* – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

*An outflow of resources embodying economic benefits in settlement* – At March 31, 20X2, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

**Conclusion** – The guarantee is subsequently measured at the higher of (a) the best estimate of the obligation, and (b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with Ind AS 18, *Revenue*.

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: 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.

Present obligation as a result of a past obligating event – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – Probable for the warranties as a whole.

Conclusion – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period.

Example: 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.

Present obligation as a result of a past obligating event – The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund purchases.

An outflow of resources embodying economic benefits in settlement – Probable, a proportion of goods are returned for refund.

Conclusion – A provision is recognised for the best estimate of the costs of refunds.

2.6.1.4 Reliable Estimate of the Obligation

- The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the balance sheet.

- Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.
Illustration 3

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?

Solution

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

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

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

2.6.2 Contingent Liabilities

- An entity should not recognise a contingent liability.
- A contingent liability should be disclosed, if the possibility of an outflow of resources embodying economic benefits is not remote.
- Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties should be treated as a contingent liability.
- The entity should recognise a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.
- Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.
- If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision should be recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).
The principles describing provisions and contingent liabilities is as follows:

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<thead>
<tr>
<th>Description</th>
<th>Action</th>
<th>Disclosure</th>
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<tbody>
<tr>
<td>There is a present obligation that probably requires an outflow of resources.</td>
<td>A provision is recognised.</td>
<td>Disclosures are required for the provision.</td>
</tr>
<tr>
<td>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.</td>
<td>No provision is recognised.</td>
<td>Disclosures are required for the contingent liability.</td>
</tr>
<tr>
<td>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</td>
<td>No provision is recognised.</td>
<td>No disclosure is required.</td>
</tr>
</tbody>
</table>

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

### 2.6.3 Contingent Assets

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

**Example**

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

- Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised.
- However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- A contingent asset should be disclosed, where an inflow of economic benefits is probable.
- Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements *of the period in which the change occurs.*
Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

<table>
<thead>
<tr>
<th>The inflow of economic benefits is virtually certain</th>
<th>The inflow of economic benefits is probable, but not virtually certain</th>
<th>The inflow is not probable</th>
</tr>
</thead>
<tbody>
<tr>
<td>The asset is not contingent and its recognition is appropriate</td>
<td>No asset is recognised</td>
<td>No asset is recognised</td>
</tr>
<tr>
<td>Disclosures are required</td>
<td></td>
<td>No disclosure is required</td>
</tr>
</tbody>
</table>

Tabular depiction

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

Illustration 4

X Sugars Ltd. has entered into a sale contract of ₹ 3,00,00,000 with Y Choclates 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 the goods were not delivered on time.

What provision or disclosure would X Ltd. need to make at year end?
Solution

As per the standard, where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out in Ind AS 37.

So X Sugars Ltd. would need to disclose the contingent asset of ₹ 2,12,50,000 (₹ 2,50,00,000 x 85%) at the end of the financial year 20X1-20X2.

It would also need to make a provision of ₹ 30,00,000 towards the claim of Y Chocolates Ltd.

2.7 MEASUREMENT

2.7.1 Best Estimate

- The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- The estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and in some cases, reports from independent experts, for example, in legal cases, expert legal advice might be taken. The evidence considered includes any additional evidence provided by events after the reporting period.
- Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured
involves a large population of items, for example, customer refunds, warranties, etc., the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is ‘expected value’. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60% or 90%.

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

Illustration 5

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

Solution

The expected value of the cost of repairs is:

\[(75\% \text{ of nil}) + (20\% \text{ of 1m}) + (5\% \text{ of 4m}) = ₹4,00,000\]

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

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

Example

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.

Example

If an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of ₹1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.
The provision should be measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under Ind AS 12.

2.7.2 Risks and Uncertainties

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

For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case.
- Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.
- Risk adjustment can be accounted for in number of ways such as:
  - Adding it to the expected present value of future outflows.
  - Adjusting the estimates of future outflows.
  - Adjusting the discount rate.
- Disclosure of the uncertainties surrounding the amount of the expenditure should be made.

2.7.3 Present Value

- Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.
- Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions should therefore be discounted, where the effect is material.
- Ind AS 37 does not require cash flows to be discounted unless this has a material effect.
- The expected present value of outflows are calculated as follows:
  - Each outcome is discounted to its present value.
The present value of outcomes are weighted by their associated probabilities.

- **The discount rate (or rates) should be a pre-tax rate (or rates)** that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

- The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

**Illustration 6**

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

**Solution**

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

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

### 2.7.4 Future Events

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

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

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

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

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

**Illustration 7**

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?

**Solution**

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

### 2.7.5 Expected Disposal of Assets

- Gains from the expected disposal of assets should not be taken into account in measuring a provision.

- Gains on the expected disposal of assets should not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.

- Instead, an entity should recognise gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned.

### 2.8 REIMBURSEMENTS

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

- In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

- Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers’ warranties). The other party may either reimburse amounts paid by the entity.
or pay the amounts directly.

- In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision should be recognised for the full amount of the liability, and a separate asset for the expected reimbursement should be recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.

- In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they should not be included in the provision.

- As noted earlier, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

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

<table>
<thead>
<tr>
<th>The entity has no obligation for the part of the expenditure to be reimbursed by the other party.</th>
<th>The obligation for the amount expected to be reimbursed remains with the entity and it is virtually certain that reimbursement will be received if the entity settles the provision.</th>
<th>The obligation for the amount expected to be reimbursed remains with the entity and the reimbursement is not virtually certain if the entity settles the provision.</th>
</tr>
</thead>
<tbody>
<tr>
<td>No disclosure is required.</td>
<td>The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability. The reimbursement is disclosed together with the amount recognised for the reimbursement.</td>
<td>The expected reimbursement is not recognised as an asset.</td>
</tr>
</tbody>
</table>
Illustration 8

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 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?

Solution

X Beauty Solutions Ltd. will get reimbursement of ₹9,00,000 (₹30,00,000 x 30%) from Y Ltd. So, X Beauty Solutions Ltd. should make a provision of ₹21,00,000 (₹30,00,000 - ₹9,00,000) in financial year 20X1-20X2 and disclose a contingent liability of ₹9,00,000. The contingent liability is recognised keeping in view the fact that in case Y Ltd. does not pay, then X Beauty Solutions Ltd. will be liable for the whole claim.

2.9 CHANGES IN PROVISIONS

- Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.
- Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Illustration 9

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?

Solution

The discount factor of 10% for 2 years is 0.827. X Telecom Ltd. will initially recognise provision for ₹82,70,000 (₹1,00,00,000 x 0.827).

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

As per the standard, the difference between the two present values i.e., ₹8,20,000 is recognised as a borrowing cost in year 1.

At the end of the Year 2, the liability would be ₹1,00,00,000.
The difference between the two present values i.e., ₹ 9,10,000 (₹ 1,00,00,000 - ₹ 90,90,000) is recognised as borrowing cost in year 2.

### 2.10 USE OF PROVISIONS

- A provision should be used only for expenditures for which the provision was originally recognised.
- Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

### 2.11 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

#### 2.11.1 Future Operating Losses

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

**Illustration 10**

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?

**Solution**

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

2.11.2 Onerous contracts

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

**Example: An onerous contract**

An entity operates profitably from a factory that it has leased under an operating lease. During March 20X1 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user. It is assumed that a reliable estimate can be made of any outflows expected. The entity has 31 March year-end.

**Present obligation as a result of a past obligating event** – The obligating event is the signing of the lease contract, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits in settlement** – When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the entity accounts for the lease under Ind AS 17, Leases.)

**Conclusion** – A provision is recognised for the best estimate of the unavoidable lease payments.

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

- Ind AS 37 defines an onerous contract as a contract in which the unavoidable costs of
meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

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

Illustration 11

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?

Solution

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

2.11.3 Restructuring

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

(a) sale or termination of a line of business;
(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
(c) changes in management structure, for example, eliminating a layer of management; and
(d) fundamental reorganisations that have a material effect on the nature and focus of the entity’s operations.

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

A constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least:
   (i) the business or part of a business concerned;
(ii) the principal locations affected;
(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
(iv) the expenditures that will be undertaken; and
(v) when the plan will be implemented; and

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

Example: Closure of a division – no implementation before end of the 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.

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

**Conclusion** – No provision is recognised.

Example: 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.

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

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

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

- Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (i.e., setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.
For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

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

(a) started to implement the restructuring plan; or

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

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

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

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

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

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

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity.

A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

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

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

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

Illustration 12

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?

Solution

As per Ind AS 37, the conditions prescribed are:

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

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

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

2.12 DISCLOSURE

- For each class of provision, an entity should disclose:
  (a) the carrying amount at the beginning and end of the period;
  (b) additional provisions made in the period, including increases to existing provisions;
  (c) amounts used (i.e., incurred and charged against the provision) during the period;
  (d) unused amounts reversed during the period; and
  (e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required to be disclosed.

- An entity should disclose the following for each class of provision:
  (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
  (b) an indication of the uncertainties about the amount or timing of those outflows.

    Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events; and
  (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.
Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured in the standard;
(b) an indication of the uncertainties relating to the amount or timing of any outflow; and
(c) the possibility of any reimbursement.

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

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

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

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

It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.

Where any of the information required by the standard is not disclosed because it is not practicable to do so, that fact should be stated.

In extremely rare cases, disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

**Illustration 16 - Warranties**

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

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

2.13 LEVIES (APPENDIX C OF IND AS 37)

2.13.1 Appendix C deals with

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

2.13.2 Appendix C does not deal with

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

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

2.13.3 What is a Levy?

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

It excludes

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

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

2.13.4 Accounting Principles

- If and activity triggers the payment of the levy, it will be considered as an obligating event that gives rise to a liability to pay a levy
Example
If the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to create a present obligation.

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

- The preparation of financial statements under the going concern assumption does not imply that an entity has a present obligation to pay a levy that will be triggered by operating in a future period.

- The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (i.e., if the activity that triggers the payment of the levy, as identified by the legislation, occurs over a period of time).

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

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

- An entity shall apply the same recognition principles in the interim financial report that it applies in the annual financial statements. As a result, in the interim financial report, a liability to pay a levy:
  (a) shall not be recognised if there is no present obligation to pay the levy at the end of the interim reporting period; and
  (b) shall be recognised if a present obligation to pay the levy exists at the end of the interim reporting period.

- An entity shall recognise an asset if it has prepaid a levy but does not yet have a present obligation to pay that levy.
**2.14 SIGNIFICANT DIFFERENCES IN IND AS 37 VIS-A-VIS AS 29**

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Particulars</th>
<th>Ind AS 37</th>
<th>AS 29 (Revised)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Constructive obligations and Change in the Definition of Provision and Obligating Event</td>
<td>Ind AS 37 requires creation of provisions in respect of constructive obligations. Definitions of provision and obligating event have been revised in Ind AS 37, while the terms ‘legal obligation’ and ‘constructive obligation’ have been inserted and defined in Ind AS 37. Similarly, the portion of existing AS 29 pertaining to restructuring provisions has been revised in Ind AS 37.</td>
<td>AS 29 requires creation of provisions in respect of constructive obligations also. It requires creation of provisions arising out of normal business practices, custom and a desire to maintain good business relations or to act in an equitable manner.</td>
</tr>
<tr>
<td>2.</td>
<td>Discounting</td>
<td>When the effect of time value of money is material, discounting is required.</td>
<td>Discounting is not permitted except for decommissioning, restoration and similar liabilities associated with property, plant and equipment</td>
</tr>
<tr>
<td>3.</td>
<td>Contingent asset</td>
<td>Contingent assets are not recognised but disclosed in the financial statements when an inflow of economic benefits is probable.</td>
<td>Contingent assets are neither recognised nor disclosed in the financial statements and are usually disclosed as part of Board of Directors’ report.</td>
</tr>
<tr>
<td>4.</td>
<td>Onerous Contracts:</td>
<td>Ind AS 37 makes it clear that before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36.</td>
<td>There is no such specific provision in the existing standard</td>
</tr>
<tr>
<td>5.</td>
<td>Future Operating</td>
<td>Ind AS 37 gives an exception to this principle viz. such losses related to an</td>
<td>The existing AS 29 states that identifiable future operating</td>
</tr>
<tr>
<td>6. Additional guidance</td>
<td></td>
<td></td>
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</table>

**Losses:**
- onerous contract.
- losses up to the date of restructuring are not included in a provision.

**Ind AS 37 gives guidance on:**
(a) Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
(b) Liabilities arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment
(c) Levies (imposed by government).

**Existing AS 29 does not give such guidance.**

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**SUMMARY**

### Provisions

- Present legal or constructive obligation as a result of a past event
- Probable outflow of economic benefits to settle the obligation
- Obligation can be estimated reliably

### Contingent liability

- Possible obligations arising from a past event to be confirmed by future events not wholly within the control of the entity, or
- Present obligations arising from a past event
  - of which the outflow of economic benefits is not probable, or
  - that cannot be measured reliably

### Contingent asset

- Possible assets arising from a past event to be confirmed by future events not wholly within control of entity
The purpose of this diagram is to summarise the main recognition requirements of Ind AS 37 for provisions and contingent liabilities.

**Note:** 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.
TEST YOUR KNOWLEDGE

Practical Questions

1. In 2017, an entity involved in nuclear activities recognises a provision for decommissioning costs of ₹ 300 million. The provision is estimated using the assumption that decommissioning will take place in 60–70 years’ time. However, there is a possibility that it will not take place until 100–110 years’ time, in which case the present value of the costs will be significantly reduced. Draft the note.

2. An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of ₹ 100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by the standard. Draft the note.

3. 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.

Answers to Practical Questions

1. A provision of ₹ 300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2077 and 2087; however, there is a possibility that decommissioning will not take place until 2117–2127. If the costs were measured based upon the expectation that they would not be incurred until 2117–2127 the provision would be reduced to ₹ 136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2%.

2. Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of ₹ 100 million.
The information usually required by Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.

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

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