# Ind-AS 37 – Provisions, Contingent Assets and Contingent Liabilities

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- A provision shall be <u>recognised</u> when:
  - an entity has a present obligation (legal or constructive) that is a
  - result of a past event; and
  - it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
  - a reliable estimate can be made of the amount of the obligation.
- <u>Measurement</u> - The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

# Question

- Company A has taken on lease property for a period of 10 years w.e.f. 01.04.2014. Terms of contract provide for the following –

a) Company A to hand over the leasehold property in its original conditions i.e. demolishing additional walls constructed, portioning done etc.

b) Replace the fabrics and carpets etc. if because of use they need replacement.

- Company A has estimated cost for item A as Rs. 25 Lacs while for item B it is estimated as Rs. 10 Lacs.
- State how much provision should be recognised for the year ended 31$^{st}$ March, 2015

# Example of Best Estimate -

- Best estimate is either –
- Weighted average of all possible outcomes by their associated probabilities, known as ‘expected value’ or
- The single most likely outcome.
- Example – An entity is a retail chain distributing shoes. It faces 200 legal claims filed by its distributors. Each with a 30 per cent likelihood of success with no cost and a 70 per cent likelihood of failure with the cost of each claim to be Rs. 20,000.
- Using expected value method, the best estimate of the provision should be measured using the following formula:
- 70% × 200 claims × Rs. 20,000 per claim = Rs 28,00,000.

# Types of Obligations –

- **<u>Legal Obligation</u>** –
  - An obligation that derives from: a contract (explicit or implicit terms); legislation; or other operation of law.
- **<u>Constructive Obligation</u>** –
  - an obligation that derives from an entity’s actions where- 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
  - as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.
- **<u>Onerous Contracts</u>** –
  - 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.
  - If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

# Question -

- Samsung Company signed a non-cancellable lease for a property, on 1 April 2010. The lease was for a period of 10 years, at an annual rental of Rs. 480,000 payable in arrears.
- On 31 March 2014, Samsung vacated the property to move to larger premises. Samsung has the choice of signing a contract to sub-lease the property at an annual rental of Rs 120,000 for the remaining six years of the lease, payable in arrears, or immediately to pay compensation of Rs. 22 Lacs to property's landlord.
- 5% is the pre-tax rate that reflects the time value of money and the risk specific to these liabilities. The cumulative present value of Re1 for 6 years at an interest rate of 5% is Rs 5.076.
- State how much provision should Samsung take in in its books for the year ending 31 March 2014 ?

# Answer -

- The signing of the lease is a past event that creates a legal obligation to pay for the property under the terms of the contract and is an obligating event. The company should therefore create a provision for the onerous contract that arises on leaving the premises. This is calculated as the excess of unavoidable costs of the contract over the economic benefits to be received from it. The unavoidable cost is the lower of the cost of fulfilling the contract and the penalty that arises from failing to fulfill it.
- The effect of the time value of money over six years is material, so the provision should be discounted to its present value.
- The present value of the sub-lease arrangement is Rs. 18,27,360 ((Rs. 480,000 - Rs120,000) x 5.076). As this is less than the Rs 22 Lacs

# Accounting for 6 years -

| Year | Liability Op Bal | Int @ 5% | Rent recd | Rent paid | Liability cl bal |
|---|---|---|---|---|---|
| 1 | 1,827,360 | 91,368 | 120,000 | -480,000 | 1,558,728 |
| 2 | 1,558,728 | 77,936 | 120,000 | -480,000 | 1,276,664 |
| 3 | 1,276,664 | 63,833 | 120,000 | -480,000 | 980,498 |
| 4 | 980,498 | 49,025 | 120,000 | -480,000 | 669,523 |
| 5 | 669,523 | 33,476 | 120,000 | -480,000 | 342,999 |
| 6 | 342,999 | 17,150 | 120,000 | -480,000 | 149 |

Always remember to unwind the interest at the same rate at which initially CF was discounted

# Contingent assets and liabilities -

- CL = 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 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.
- CA = 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.

# Contingent Assets and Liabilities -

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

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

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

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

- Thank you