CHAPTER 6

LIABILITIES BASED ACCOUNTING STANDARDS

UNIT 1: ACCOUNTING STANDARD 15 EMPLOYEE BENEFITS

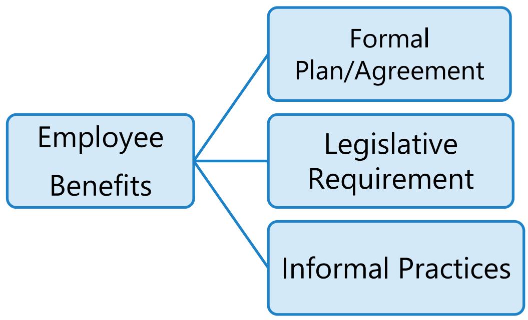
LEARNING OUTCOMES

After studying this unit, you will be able to

- Define 'Employee benefits', 'Short-term employee benefits', 'Post-employment benefits' and other related terms used in the Standard
- Enumerate various types of employee benefits
- Recognise and measure Short-term Employee Benefits, Short-term Compensated Absences and Profit-sharing and Bonus Plans along with the accounting thereof
- Classify the post-employment benefits into defined contribution plans and defined benefit plans
- Examine the various aspects inherent in these post-employment benefit plans and recognize and measure the obligations under these plans
- Apply the actuarial valuation methods and assumptions while valuing the obligations under Defined benefit plans
- Calculate the actuarial gains and losses on such plans
- Recognise gains or losses on the curtailment or settlement of a defined benefit plan
- Recognise and measure other long-term benefit and termination benefits
- Understand the disclosure requirement of these employee benefits and comply with the same.

1.1 INTRODUCTION

The Accounting Standard 15 - 'Employee Benefits' (AS 15), generally deals with all forms of employee benefits all forms of consideration given by an enterprise in exchange for services rendered by employees The objective of this Standard is to prescribe the accounting treatment and disclosure for employee benefits in the books of employer except employee share-based payments. It does not deal with accounting and reporting by employee benefit plans.



The Standard addresses only the accounting of employee benefits by employers. The Standard makes four things very clear at the outset:

(i) the Standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff);

(ii) employee benefits can be paid in cash or in kind;

(iii) employee benefits include benefits provided to employees and their dependents (spouses, children and others); and

(iv) payment can be made directly to employees, their dependent or to any other party (e.g., legal heirs, nominees, insurance companies, trust etc.).

The Standard is based on the premise that the costs associated with employees-benefits should be matched with the timing of their service. This requires assessment of the anticipated costs and their timing in future and aligning those costs over the period of their service. For example, a bonus payable to an employee for a long-term service, should ideally be spread over the period of his service and the expectations that the employee is expected to complete that service. Likewise, pension payable to an employee must be recognized as a cost during the service period itself, irrespective of the fact that the pension is payable after the service is completed.

Illustration 1

What are the kinds of employees covered in the revised AS 15 and whether a formal employer employee relationship is necessary or not, for benefits to be covered under the Standard?

Solution

The Standard does not define the term "employee". Paragraph 6 of the Standard states that 'an employee may provide services to an enterprise on a full time, part time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The Standard is applicable to all forms of employer employee relationships. There is no requirement for a formal employer employee relationship. Several factors need to be considered to determine the nature of relationship.

Generally, 'outsourcing contracts' may not meet the definition of employer - employee relationship. However, such contracts need to be carefully examined to distinguish between a "contract of service" and a "contract for services". A 'contract for services' implies a contract for rendering services, e.g., professional or technical services which is subject to limited direction and control whereas a 'contract of service' implies a relationship of an employer and employee, and the person is obliged to obey orders in the work to be performed and as to its mode and manner of performance.

Illustration 2

Whether an enterprise is required to provide for employee benefits arising from informal practices?

Solution

Paragraph 3(c) of the Standard defines employee benefits to include those informal practices that give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. The historical pattern of granting such benefits, the expectation created and the impact on the relationship with employees in the event such benefit is withdrawn should be considered in determining whether the informal practice gives rise to a benefit covered by the Standard. For example, where an employer has a practice of making a lumpsum payment on occasion of a festival or regularly grants advances against informal benefits to employees it would be necessary to provide for such benefits.

Careful judgement should be applied in assessing whether an obligation has arisen particularly in instances where an enterprise's practice is to provide improvements only during the collective bargaining process and not during any informal process. If the employer has not set a pattern of benefits that can be projected reliably to give rise to an obligation there is no requirement to provide for the benefits.

However, if the practice established by an employer was that of a consistent benefit granted either as part of union negotiations or otherwise that clearly established a pattern (e.g., a cost of living adjustment or fixed rupee increase), it could be concluded that an obligation exists and that those additional benefits should be included in the measurement of the benefit obligation.

Employee benefits include:

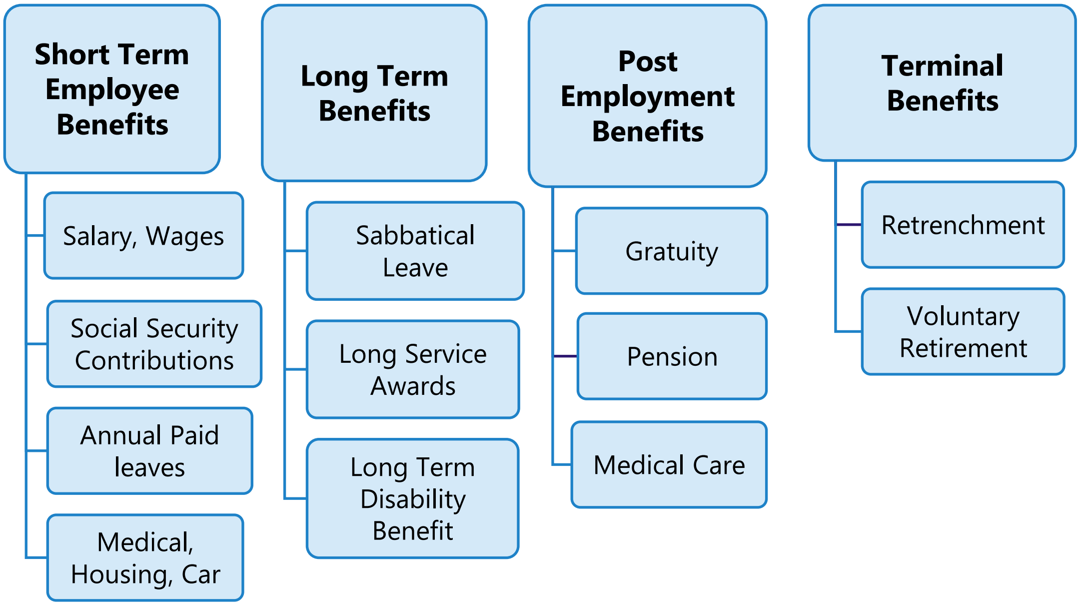
(a) Short-term employee benefits (e.g., wages, salaries, paid annual leave and sick leave, profit sharing bonuses etc. (payable within 12 months of the year-end) and non-monetary benefits for current employees.

(b) Post-employment benefits (e.g., gratuity, pension, provident fund, post-employment medical care etc.).

(c) long-term employee benefits (e.g., long-service leave, long-term disability benefits, bonuses not wholly payable within 12 months of the year end etc.), and

(d) termination benefits (e.g. VRS payments)

The Standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.



1.2 APPLICABILITY

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. This Standard is applicable predominantly for Level 1 enterprises and applied to other entities with certain relaxations.

1.3 MEANING OF THE TERM "EMPLOYEE BENEFITS"

The term employee is not defined under the standard AS 15 does not define who is an 'employee', but states in that "an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel". This suggests that the intention was for the term 'employee' to apply more widely than simply to persons with a contract of employment as 'casual' and 'temporary' staff may frequently not have such contracts.

The following indicators may suggest an employee relationship may be more likely to exist, and may help in making individual judgements:

- A contract of employment exists;
- Individuals are considered employees for legal/tax/social security purposes;
- There is a large amount of oversight and direction by the employer and necessary tools, equipment and materials are provided by the employer;
- Services are performed at a location specified by the employer;

Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:

- Has no other clients;
- Has served the employer for a long period;
- Faces little or no financial risk;
- Requires the explicit permissions of the employer to concurrently undertake additional employment elsewhere.

1.4 SHORT-TERM EMPLOYEE BENEFITS

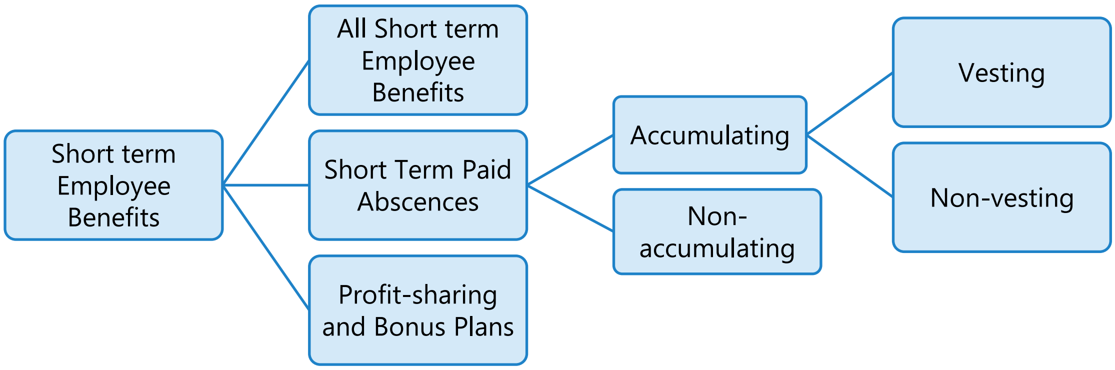
- Short-term employee benefits (other than termination benefits) are payable within twelve months after the end of the period in which the service is rendered.
- Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost.
- Short-term employee benefits are broadly classified into four categories:

  (i) regular period benefits (e.g., wages, salaries);

  (ii) short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);

  (iii) profit sharing and bonuses payable within twelve months after the end of the period in which employee render the related services and

  (iv) non-monetary benefits (e.g., medical care, housing, cars etc.)



1.4.1 All Short-term Employee Benefits

- The Standard lays down some general recognition criteria for all short-term employee benefits. There are further requirements in respect of short-term compensated absences and profit sharing and bonus plans.
- The general criteria is that an enterprise should recognize as an expense (unless another accounting standard permits a different treatment) the undiscounted amount of all short-term employee benefits attributable to services that been already rendered in the period.
- Any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate.

Illustration 3

Entity XY is required to pay salary of ₹ 2 crore for the year 20X1-X2. It actually paid a salary of ₹ 1.90 crore up to 31st March 20X2, and balance in April 20X2. Determine the actual costs to be recognized in the year 20X1-X2 and any amounts to be shown through balance sheet.

Solution

Total expense for the year (20X1-X2)	₹ 2 crore
Amount to be shown under liability (unpaid)	₹ 2 crore – 1.90 ₹crore
	= ₹ 10 lakhs

1.4.2 Short-term Compensated Absences

Entitlement to compensated absences falls into two categories:

(a) Accumulating

- Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full.
- Accumulating compensated absences may be

  (i) Vesting

  It implies that employees are entitled to a cash payment for unused entitlement on leaving the enterprise

  (ii) Non-vesting

  It implies that when employees are not entitled to a cash payment for unused entitlement on leaving. An obligation arises as employees render service that increases their entitlement to future compensated absences.
- The expected cost of accumulating compensated absences should be recognized when employees render the service that increase their entitlement to future compensated absences.
- 'An enterprise should measure the expected cost of accumulating compensated absences as the *additional amount* that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'.
- No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

Example

An enterprise has 100 employees, who are each entitled to five working days of leave for each year. Unused leave may be carried forward for one calendar year. The leave is taken first out of the current year's entitlement and then out *of any balance brought forward from the previous year (a LIFO basis). At 31st December, 20X4, the average unused entitlement is two days per employee. The enterprise expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of leave in 20X5 and that the remaining eight employees will take an average of six and a half days each.*

The enterprise expects that it will pay an additional 12 days of pay as a result of the unused entitlement that has accumulated at 31st December, 20X4 (one and a half days each, for eight employees). Therefore, the enterprise recognises a liability, as at 31st December, 20X4, equal to 12 days of pay.

(b) Non-accumulating

- Non-accumulating compensated absences (e.g., maternity leave) do not carry forward and are not directly linked to the services rendered by employees in the past. Therefore, an enterprise recognizes no liability or expense until the time of the absence.
- In other words, the cost of non-accumulating absences should be recognized as and when they arise.

Exception

Small and Medium-sized Company and Micro, Small and Medium-sized Enterprises (Levels IV, III and II non-corporate entities) may not comply with short term absences to the extent they deal with recognition and measurement of absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment of unused entitlement on leaving).

1.4.3 Profit-sharing and Bonus Plans

Recognition of expenses for profit sharing and bonus plans would depend on fulfillment of conditions mentioned the Standard. The conditions are:

(a) Enterprise has a present obligation to make such payments as a result of past events; and

(b) Reliable estimate of the obligation can be made.

The second condition can be satisfied only when the profit sharing and bonus plans contained a formula for determining the amount of benefit. The enterprise should recognize the expected cost of profit sharing and bonus payments in the financial statements.

Example

A profit-sharing plan requires an enterprise to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of net profit. The enterprise estimates that staff turnover will reduce the payments to 2.5% of net profit.

The enterprise recognises a liability and an expense of 2.5% of net profit.

Illustration 4

Whether an entitlement to earned leave which can be carried forward to future periods is a short -term employee benefit or a long-term employee benefit.

Solution

Paragraph 7.2 of the Standard defines 'Short-term' benefits as employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service. Paragraph 8(b) of the Standard illustrates the term 'Short -term benefits' to include "short term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service".

Paragraph 7.2 of the Standard uses "falls due" as the basis, paragraph 8(b) of the Standard uses "expected to occur" as the basis to illustrate classification of short term compensated absences. A reading of paragraph 8(b) together with paragraph 7.2 would imply that the classification of short -term compensated absences should be only when absences have "fallen due" and are also "expected to occur". In other words, where employees are entitled to earned leave which can be carried forward to future periods, the benefit would be a 'short-term benefit' provided the employee is entitled to either encash or utilise the benefit during the twelve months after the end of the period when the employee became entitled to the leave and is also expected to utilise the leave.

Where there are restrictions on encashment and/or availment, clearly the compensated absence has not fallen due and the benefit of compensated absences is more likely to be a long-term benefit. For example, where an employee has 100 days of earned leave which he is entitled to an unlimited carry forward, but the rules of the enterprise allow him to encash/utilise only 30 days during the next twelve months, the benefit would be considered as a 'long-term' benefit. In some situations, where there is no restriction but the absence is not expected to wholly occur in the next twelve months, the benefit should be considered as 'long-term'. For example, where an employee has 400 days carry forward earned leave and the past pattern indicates that the employees are unlikely to avail / encash the entire carry forward during the next twelve months, the benefit would not be 'short-term'.

Whilst it is necessary to consider the earned leave which "falls due", the pattern of actual utilisation/encashment by employees, although reflective of the behavioural pattern of employees, does determine the status of the benefit, i.e., whether 'short-term' or 'long-term'. The value of short-term benefits should be determined without discounting and if the benefit is determined as long-term, it would be recognised and measured as "Other long-term benefits" in accordance with paragraph 129 of the Standard.

The categorisation in 'short-term' or 'long-term' employee benefits should be done on the basis of the overall behavioural pattern of all the employees of the enterprise and not on individual basis.

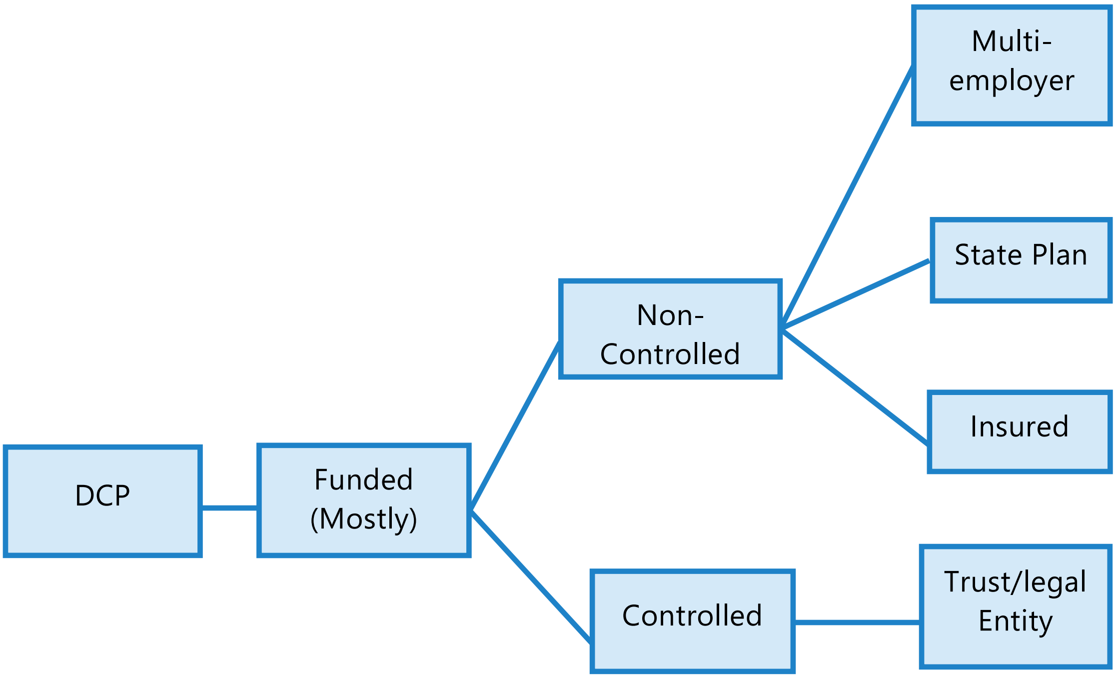
Illustration 5

In case an enterprise allows unutilised employee benefits, e.g., medical care, leave travel, etc., to be carried forward, whether it is required to recognise a provision in respect of carried forward benefits.

Solution

A provision should be recognised for all benefits (conditional or unconditional) which an employee becomes entitled to as a result of rendering of the service and should be recorded as part of the cost of service rendered during the period in which the service was rendered which resulted the entitlement. In estimating the cost of such benefit the probability of the employee availing such benefit should be considered.

1.5 POST EMPLOYMENT BENEFITS: DEFINED CONTRIBUTION VS DEFINED BENEFITS



The accounting treatment and disclosures required for a post-employment benefit plan depend upon whether it is a defined contribution or a defined benefit plan. In addition to addressing defined contribution and defined benefit plans generally, the Standard also gives guidance as to how its requirements should be applied to insured benefits, multi-employment benefit plans.

1. **Defined contribution plans** (DCP) are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. A common example of Defined Contribution plans is Provident Fund.

2. **Defined benefit plans** are post-employment benefit plans other than defined contribution plans. In defined benefits plans, the actuarial and investment risk fall on the employer.

In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

1.6 IS THE GRATUITY SCHEME A DEFINED CONTRIBUTION OR DEFINED BENEFIT SCHEME?

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either:

(a) pay the employee benefits directly when they fall due; or

(b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

On the asset side, a question arises as to whether the funds under the scheme as certified by LIC would be treated as plan assets or reimbursement rights. The distinction is important (though both are measured on fair valuation basis) because plan assets are reduced from the defined benefit obligation and the net amount is disclosed in the balance sheet, whereas, in the case of reimbursement rights, the defined benefit obligation and the reimbursement rights are shown separately as liability and asset on the balance sheet. This would have the impact of making the balance sheet heavy both on the asset side as well as the liabilities side.

1.7 ACCOUNTING TREATMENT

In the Balance Sheet of the enterprise, 'the amount recognized as a defined benefit liability should be the net total of the following amounts:

(a) the present value of the defined benefit obligation at the balance sheet date;

(b) *minus* any past service cost not yet recognized;

(c) *minus* the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.'

In case where fair value of plan assets is high, it may so happen that the net amount under defined benefit liability turns negative (giving rise to net assets). AS 15 states that the enterprise, in such a situation, should measure the resulting asset at the lower of:

(i) the amount so determined; and

(ii) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The recognition of expenses relating to defined benefits in the Statement of Profit and Loss is stated in Para 61 of the Standard. The Standard identifies *seven* components of defined employee benefit costs:

(a) current service cost;

(b) interest cost;

(c) the expected return on any plan assets (and on any reimbursement rights);

(d) actuarial gains and losses (to the extent they are recognized);

(e) past service cost (to the extent they are recognized);

(f) the effect of any curtailments or settlements; and

(g) the extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(b) of the Standard.

A settlement occurs when an employer enters into a transaction that eliminates all further legal or constructive obligations for part or whole of the benefits provided under a defined benefit plan. For example, the commuted portion of pension. A curtailment occurs when an employer either commits to reduce the number of employees covered by a plan or reduces the benefits under a plan. The gains or losses on the settlement or curtailment of a defined benefit plan should be recognized when the settlement or curtailment occurs.

1.8 DISCLOSURES

Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists.

As required by AS 29, "Provisions, Contingent Liabilities and Contingent Assets" an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

As required by AS 5, "Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies" an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period.

Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

Where required by AS 18, "Related Party Disclosures", an enterprise discloses information about termination benefits for key management personnel.

When drafting AS 15 (revised), the Standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallized at this stage. AS 15 requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

1.9 ACTUARIAL ASSUMPTIONS

The actuarial assumptions should be unbiased and mutually compatible. They are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. They should be neither imprudent nor excessively conservative, and should reflect the economic relationships between factors such as inflation, rates of salary increase, return on plan assets and discount rates.

AS 15 explains that actuarial assumptions comprise:

(a) demographic assumptions about the future characteristics of current and former employees (and their dependents) who are eligible for benefits. Demographic assumptions deal with matters such as:

   (i) mortality, both during and after employment;

   (ii) rates of employee turnover, disability and early retirement;

(iii) the proportion of plan members with dependents who will be eligible for benefits;

(iv) claim rates under medical plans; and

(b) financial assumptions, dealing with items such as:

(i) the discount rate

(ii) future salary and benefit levels

(iii) in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments and

(iv) the expected rate of return on plan assets.

Financial assumptions: Financial assumptions should be based on market expectation at the balance sheet date for the period over which the post-employment benefit obligations will be settled. Discount rates and other financial assumptions should not be inflation-adjusted unless such measures are more reliable (e.g. where benefits are index-linked)

1.10 ACTUARIAL GAINS AND LOSSES

Actuarial gains and losses comprise:

- experience adjustments (the effects of difference between the previous actuarial assumptions and what has actually occurred); and
- the effects of changes in actuarial assumptions.

Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense.

Illustration 6

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalization of accounts, taking note of the mandatory accounting standards.

Solution

According to AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 7

As on 1st April, 20X1 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 20X1 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 20X2 the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Actuarial losses on the obligations for the year 20X1-20X2 were ₹ 600.

On 1st April, 20X1, the company made the following estimates, based on its market studies, understanding and prevailing prices.

	%
Interest & dividend income, after tax payable by the fund	*9.25*
Realised and unrealised gains on plan assets (after tax)	*2.00*
Fund administrative costs	*(1.00)*
Expected Rate of Return	*10.25*

You are required to find the expected and actual returns on plan assets.

Solution

Computation of Expected and Actual Returns on Plan Assets

	₹
Return on ₹ 1,00,000 held for 12 months at 10.25%	10,250
Return on ₹ 30,000 (49,000-19,000) held for six months at 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets for 20X1-20X2	11,750

Fair value of plan assets as on 31 March, 20X2		1,50,000
Less: Fair value of plan assets as on 1 April,20X1	1,00,000	
Contributions received	49,000	(1,49,000)
		1,000
Add: Benefits paid		19,000
Actual return on plan assets		20,000

Alternatively, the above question may be solved without giving compound effect to rate of return.

Illustration 8

Rock Star Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. If the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Rock Star Ltd. estimates the share of unamortized service cost that relates to the part of the obligation at ₹ 18 (10% of ₹ 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

(a) Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.

(b) The fair value of plan assets on the date is estimated at ₹ 5,100.

(c) The unamortized past service cost is ₹ 180.

(d) Curtailment reduces the obligation by ₹ 600, which is 10% of the gross obligation.

Solution

Gain from curtailment is estimated as under:

	₹
Reduction in gross obligation	600
Less: Proportion of unamortised past service cost	(18)
Gain from curtailment	582

The liability to be recognised after curtailment in the balance sheet is estimated as under:

	₹
Reduced gross obligation (90% of ₹ 6,000)	5,400
Less: Fair value of plan assets	(5,100)
	300
Less: Unamortised past service cost (90% of ₹ 180)	(162)
Liability to be recognised in the balance sheet	138

Illustration 9

An employee Roshan has joined a company XYZ Ltd. in the year 20X1. The annual emoluments of Roshan as decided is ₹ 14,90,210. The company also has a policy of giving a lump sum payment of 25% of the last drawn annual salary of the employee for each completed year of service if the employee retires after completing minimum 5 years of service. The salary of the Roshan is expected to grow @ 10% per annum.

The company has inducted Roshan in the beginning of the year and it is expected that he will complete the minimum five year term before retiring. Thus he will get 5 yearly increment.

What is the amount the company should charge in its Profit and Loss account every year as cost for the Defined Benefit obligation? Also calculate the current service cost and the interest cost to be charged per year assuming a discount rate of 8%.

(P.V factor for 8% - 0.735, 0.794, 0.857, 0.926, 1)

Solution

Calculation of Defined Benefit Obligation (DBO)

Expected last drawn salary = ₹ 14,90,210 x 110% x 110% x 110% x 110% x 110%

= ₹ 24,00,000

Defined Benefit Obligation (DBO) = ₹ 24,00,000 x 25% x 5 = ₹ 30,00,000

Amount of ₹ 6,00,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost

Year	Equal apportioned amount of DBO [i.e. ₹ 30,00,000/5 years]	Discounting @ 8% PV factor	Current service cost (Present Value)
a	b	c	d = b x c
1	6,00,000	0.735 (4 Years)	4,41,000
2	6,00,000	0.794 (3 Years)	4,76,400
3	6,00,000	0.857 (2 Years)	5,14,200
4	6,00,000	0.926 (1 Year)	5,55,600
5	6,00,000	1 (0 Year)	6,00,000

Calculation of Interest Cost to be charged per year

Year	*Opening balance*	*Interest cost*	*Current service cost*	*Closing balance*
a	**b**	**c = b x 8%**	**d**	**e = b + c + d**
1	0	0	4,41,000	4,41,000
2	4,41,000	35,280	4,76,400	9,52,680
3	9,52,680	76,214	5,14,200	15,43,094
4	15,43,094	1,23,447	5,55,600	22,22,141
5	22,22,141	1,77,859*	6,00,000	30,00,000

*Due to approximations used in calculation, this figure is adjusted accordingly.

1.11 OTHER LONG TERM EMPLOYEE BENEFITS

Other long-term employee benefits include, for example:

(a) long-term compensated absences such as long-service or sabbatical leave;

(b) jubilee or other long-service benefits;

(c) long-term disability benefits;

(d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and

(e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

1.12 TERMINATION BENEFITS

Termination Benefits are employee benefits payable as a result of either an enterprise's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept voluntary redundancy in exchange for those benefits (e.g., payments under VRS). Termination benefits are recognized by an enterprise as a liability and an expense only when the enterprise has

(i) a detailed formal plan for the termination which is duly approved, and

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

Where the termination benefits fall due within twelve months after the balance sheet date, an *undiscounted* amount of such benefits should be recognized as liability in the balance sheet with a corresponding charge to Profit & Loss Account. However, when the termination benefits fall due more than twelve months after the balance sheet date, such benefits should be discounted using an appropriate discount rate. Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees expected to accept the offer. Where there is uncertainty with regard to the number of employees who will accept an offer of voluntary redundancy, a contingent liability exists and should be so disclosed as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

Reference: The students are advised to refer the full text of AS 15 "Employee Benefits" (Revised 2005).

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Gratuity and Pension would be examples of:*

   (a) *Short-term employee benefits*

   (b) *Long-term employee benefits*

   (c) *Post-employment benefits.*

   (d) *None of the above.*

2. *Non-accumulating compensating absence is commonly referred to as:*

   (a) *Earned Leave*

   (b) *Sick Leave*

   (c) *Casual leave*

   (d) *All of the above*

3. *The plans that are established by legislation to cover all enterprises and are operated by Governments include:*

   (a) *Multi-Employer plans*

   (b) *State plans*

   (c) *Insured Benefits*

   (d) *Employee benefit plan*

4. *Best estimates of the variable to determine the eventual cost of post-employment benefits is referred to as:*

   (a) *Employer's contribution*

   (b) *Actuarial assumptions*

   (c) *Cost to Company*

   (d) *Employee's contribution*

5. *Actuarial gains / losses should be:*

   (a) *Recognised through reserves*

(b) Charged over the expected life of employees

(c) Charged immediately to Profit and Loss Statement

(d) Do not charged to Profit and Loss Statement

Theoretical Questions

6. *What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS 15?*

Scenario based Questions

7. *A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively, employees can claim a lump sum amount equal to one month pay last drawn.*

   The company's contentions in this matter are:

   (i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.

   (ii) Since it is not related to the length of service of the employees, it is accounted for on claim basis.

   State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.

8. *The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.20X2 calculate the actual return on plan assets:*

- Benefits paid	***2,00,000***
- Employer contribution	*2,80,000*
- Fair market value of plan assets on 31.03.20X2	*11,40,000*
- Fair market value of plan assets as on 31.03.20X1	*8,00,000*

9. *The fair value of plan assets of Anupam Ltd. was ₹ 2,00,000 in respect of employee benefit pension plan as on 1st April, 20X1. On 30th September, 20X1 the plan paid out benefits of ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 20X2 the fair value of plan assets was ₹ 3,00,000. On 1st April, 20X1 the company made the following estimates, based on its market studies and prevailing prices.*

	%
Interest and dividend income (after tax) payable by fund	*10.25*
Realized gains on plan assets (after tax)	*3.00*
Fund administrative costs	*(3.00)*
Expected rate of return	*10.25*

Calculate the expected and actual returns on plan assets as on 31st March, 20X2, as per AS 15.

ANSWERS/SOLUTIONS

Answer to the Multiple Choice Questions

1.	(c)	**2.**	(c)	**3.**	(b)	**4.**	(b)	**5.**	(c)		

Answer to the Theoretical Questions

6. There are four types of employee benefits according to AS 15 (Revised 2005). They are:

(a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and

(d) termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Statement establishes separate requirements for each category.

The objective of AS 15 is to prescribe the accounting and disclosure for employee benefits. The statement requires an enterprise to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Answer to the Scenario based Questions

7. The present case falls under the category of defined benefit scheme under Para 49 of AS 15 (Revised) "Employee Benefits". The said para encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).

(2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

8.

		₹
Fair value of plan assets on 31.3.20X1		8,00,000
Add: Employer contribution		2,80,000
Less: Benefits paid		(2,00,000)
	(A)	8,80,000
Fair market value of plan assets at 31.3.20X2	(B)	11,40,000
Actual return on plan assets	(B-A)	2,60,000

9. Computation of Expected Returns on Plan Assets as on 31st March, 20X2, as per AS 15

	₹
Return on opening value of plan assets of ₹ 2,00,000 (held for the year) @ 10.25%	20,500
Add: Return on net gain of ₹ 30,000 (i.e. ₹ 55,000 – ₹ 25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets as on 31st March, 20X2	22,000

Computation of Actual Returns on Plan Assets as on 31st March, 20X2, as per AS 15

	₹	₹
Fair value of Plan Assets as on 31st March, 20X2		3,00,000
Less: Fair value of Plan Assets as on 1st April, 20X1	(2,00,000)	
Add: Contribution received as on 30th September, 20X1	55,000	(2,55,000)
		45,000
Add: Benefits paid as on 30th September, 20X1		25,000
Actual returns on Plan Assets as on 31st March, 20X2		70,000

UNIT 2: AS 29 (REVISED)

PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the –

- Meaning of 'Executory contracts', 'Provision', 'Liability, Obligating event' and other related terms used in the standard;
- Need for recognition of provision;
- Definition of Present Obligation and Past Event;
- Probable Outflow of Resources Embodying Economic Benefits;
- Application of the Recognition and Measurement Rules;
- Disclosure requirements as per the Standard.

2.1 INTRODUCTION

AS 29 (Revised) came into effect in respect of accounting periods commenced on or after 1-4-2004. The objective of AS 29 (Revised) is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of AS 29 (Revised) is also to lay down appropriate accounting for contingent assets.

Companies would create provisions on arbitrary basis when profits in a particular year is more and then reverse those provisions when profits are lower in subsequent years. This would lead to manipulation of profits. This is popularly known as 'profit smoothing".

Thus, there is a need for certain parameters on the basis of which provisions are measured and recognised, as they impact both Profit and Loss Statement and Balance Sheet (creation of an expense and creation of a liability).

AS-29 prescribes the guidance in respect of recognition, measurement and disclosures of provisions, contingent liabilities and contingent assets.

The standard clearly defines the role of management while making an estimate for creating provisions and the auditors to vouch for the correctness or otherwise of the estimate made by the management. This ensures that manipulations do not take place at the time of creation of provisions.

Earlier, the companies were not recognising the liability on the ground of uncertainty regarding its timing or amount. With the issuance of AS 29, transactions which qualify for creating a provision need to be accounted for in the Balance sheet as a liability.

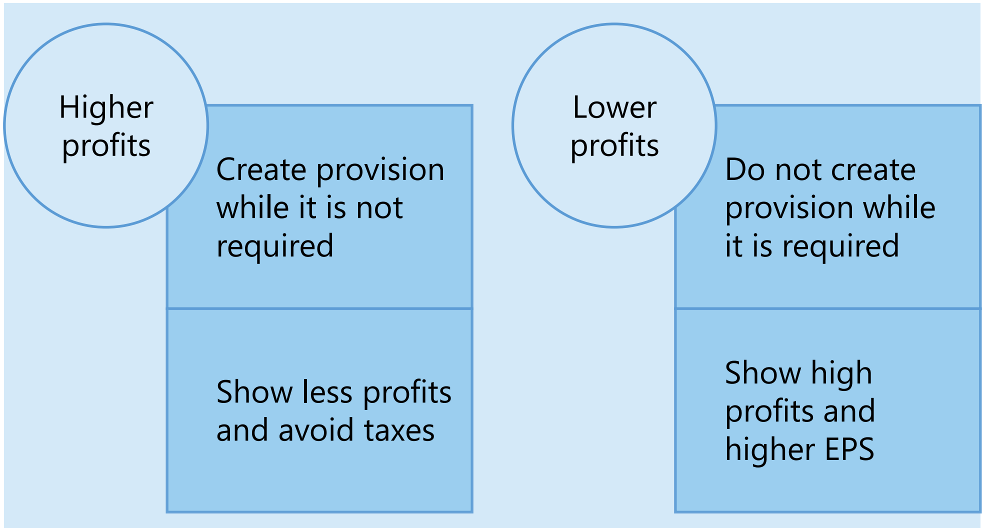
Example 1

During 20X1, XY Enterprise has made lower amount of profits. However, to ensure that the Earnings Per Share do not decline significantly, XY Enterprise does not provide for a warranty amount which should have been provided for. XY is confident of higher amount of profits during later years, and would like to take this provision to the later stage. This ensures consistent performance for the company throughout the period. With AS 29, this anomaly stands removed.

Example 2

During 20X1, AB Shops has made huge profits during a particular year. This may have resulted in payment of taxes on these profits. Further, AB Shop's management foresees challenges in operations in later years, and therefore, low profits. AB Shop did not create a provision during 20X2 which should have been otherwise made. However, to get the desired impact, AB Shop created the provision in 20X1. Since, the intention of management is not to reflect a true and fair view; AS-29 would ensure appropriate provisions are made in 20X2 only.

AS 29 helps to ensure transparency of information in Financial Statements.



Thus, an accounting standard on provisions is essential to rule out the potential scope for companies to manipulate profits and provisions are made on valid grounds (based on a recognition criterion being met).

2.2 SCOPE

AS 29 should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, other than:

a. Those resulting from financial instruments that are carried at fair value;

b. Those resulting from executory contracts except where the contract is onerous;

c. Those arising in insurance enterprises from contracts with policy-holders; and

d. Those covered by another Accounting Standard.

Where another Accounting Standard such as AS 7; AS 9; AS 15; AS 19 and AS 22 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of AS 29.

2.3 DEFINITIONS

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.

A **Provision** is a liability which can be measured only by using a substantial degree of estimation.

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

An **Obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A Contingent liability is:

(a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(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) A reliable estimate of the amount of the obligation cannot be made.

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

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

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 enterprise; or

(b) The manner in which that business is conducted.

2.4 RECOGNITION OF PROVISION

A provision should be recognised when:

(a) An enterprise has a present obligation 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.

2.5 PRESENT OBLIGATION

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, e.g., the opinion of experts. Based on such evidence:

(a) Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Example 3

X Ltd sells refrigerators with a warranty of 6 months. The refrigerators would be repaired free of cost by X Ltd. if some problem arises during the next 6 months of sale. There is a present obligation for X Ltd because if some defect arises, X Ltd would need to incur expenses on repairs of the refrigerator. Thus, a provision is required to be made in the books of X Ltd.

Example 4

Z Ltd takes a building on lease for 10 years. The terms of the contract provide that Z Ltd must vacate the building in its original condition. Z Ltd expects that there is a likely cost of ₹ 10 lakhs to be spent at the end of 10 years for restoration. Since there is a present obligation on X Ltd at the time of entering into the lease contract, a provision to the extent of present value of this amount should be created.

2.6 PAST EVENT

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Financial statements deal with the financial position of an enterprise 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 enterprise's balance sheet are those that exist at the balance sheet date.

It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

Examples of such obligations are 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 enterprise.

Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise 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.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

Where details of a proposed new law have yet to be finalized, an obligation arises only when the legislation is virtually certain to be enacted.

2.7 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.

For the purpose of AS 29, an outflow of resources or other event is regarded as probable if 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 enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

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 is recognized (if the other recognition criteria are met).

Example 5

Kell Ltd sells laptops with a replacement warranty of 1 year. If something happens to the laptop within 1 year of purchase, the company would replace the complete laptop. A few laptops during past years have been replaced by Kell Ltd.

In the above situation, Kell Ltd would incur some expenses to replace a laptop, if something goes wrong. There is an outflow of resources expected to settle the obligation that arises by virtue of sale of laptop (past event).

Example 6

AB Ltd has received a notice from one of the customers about health issues from using the products of AB Ltd. The customer in the notice claims damages of ₹ 5,00,000.

The conditions of past event (i.e. sale of goods resulting in damage) and reliable estimate (₹ 5,00,000) have been met. However, whether an outflow of resources will be probable or not, cannot be confirmed since the customer may or may not win the case. This would be clear only when the decision will be taken by the court.

Hence, in the above situation, no provision for damages will be made. However, a disclosure of the case filed is required to be made.

2.8 RELIABLE ESTIMATE OF THE OBLIGATION

The use of estimates is an inherent part of preparing financial statements and does not undermine their reliability. Provisions require a greater degree of estimation than most other items, but AS 29 (Revised) emphasizes that it should not be impossible to determine a range of possible outcomes and, from this range, to reach an appropriate conclusion that is sufficiently reliable for the provision to be recognized. AS 29 (Revised) concludes that the circumstances in which it will not be possible to reach a reliable estimate, will be extremely rare.

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

For example: XYZ is in mining business. It is operating in a country where XYZ is legally bound to clean and restore the environment on expiry of license after 10 years. XYZ can reliably estimate the amount required to restore the environment caused by the mining business. Since it if a present obligation which cannot be avoided resulted from past event, it is probable that resources will flow out of business to settle the same and estimate can be measured reliably. XYZ is required to recognize a provision for the same.

2.9 CONTINGENT LIABILITIES

An enterprise should not recognize a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognizes 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.

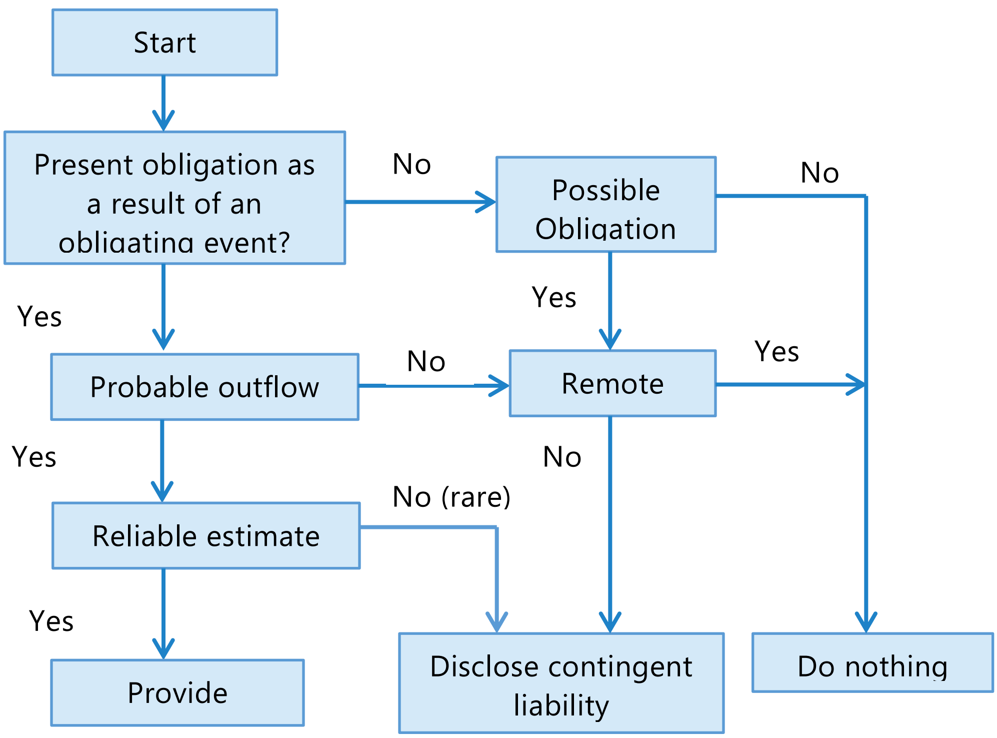
Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs.

Example: 7

A customer of XYZ has filed a case against them for providing them wrong product and not returning the same. XYZ has taken legal advice from their lawyer who believes it is not probable yet that resources may be required to settle the same.

Since it is not meeting all the criteria of provision, it will be treated as contingent liability and will just be disclosed in the notes.

Decision tree



2.10 CONTINGENT ASSETS

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

An enterprise should not recognize a contingent asset, since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognized in the financial statements of the period in which the change occurs.

Table- Provisions and contingent liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	*There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.*	*There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.*

Provision is recognised. Disclosures are required for the provision.	No provision is recognised. Disclosures are required for the contingent liability.	No provision is recognised. No disclosure is required.

2.11 MEASUREMENT: BEST ESTIMATE

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

The estimates of outcome and financial effect are determined by:

- the judgment of the management of the enterprise,
- supplemented by experience of similar transactions and,
- in some cases, reports from independent experts.

The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment.

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. Periodic unwinding of discount should be recognised in the statement of profit and loss.

The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22.

2.12 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.

2.13 FUTURE EVENTS

It is only those obligations arising from past events that exist independently of the enterprise's future actions (i.e. the future conduct of its business) that are recognized as provisions.

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.

For example, an enterprise 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 recognized 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 enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

The effect of possible new legislation is 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 usually 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.

2.14 EXPECTED DISPOSAL OF ASSETS

Gains on the expected disposal of assets are not 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 enterprise recognizes gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

2.15 REIMBURSEMENTS

An enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via:

- An insurance contract arranged to cover a risk;
- An indemnity clause in a contract; or
- A warranty provided by a supplier.

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Consequently, such a reimbursement should be recognized only when it is virtually certain that it will be received consequent upon the settlement of the obligation.

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

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

2.16 TABLE- REIMBURSEMENTS

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	*The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.*	*The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.*

The enterprise has no liability for the amount to be reimbursed.	The reimbursement is recognized as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognized for the expected reimbursement does not exceed the liability.	The expected reimbursement is not recognized as an asset.
No disclosure is required.	The reimbursement is disclosed together with the amount recognized for the reimbursement.	The expected reimbursement is disclosed.

2.17 CHANGES IN PROVISIONS

Provisions should be reviewed at each balance sheet date 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.

2.18 USE OF PROVISIONS

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

2.19 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

2.19.1 Future Operating Losses

Future operating losses do not meet the definition of a liability and the general recognition criteria; therefore, provisions should not be recognized for future operating losses.

2.19.2 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

(d) Fundamental re-organizations that have a material effect on the nature and focus of the enterprise's operations

A provision for restructuring costs is recognized only when the recognition criteria for provisions are met. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise 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.

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 enterprise.

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 balance sheet date. Such expenditures are recognized 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.

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

2.20 DISCLOSURE

For each class of provision, an enterprise 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; and

(d) Unused amounts reversed during the period.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

An enterprise 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 those outflows. Where necessary to provide adequate information, an enterprise 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 recognized for that expected reimbursement.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) An estimate of its financial effect,

(b) An indication of the uncertainties relating to any outflow; and

(c) The possibility of any reimbursement.

Where any of the information required by above paragraph 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 by AS 29 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise 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 1

At the end of the financial year ending on 31st December, 20X1, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	*Loss (₹)*
In respect of five cases (Win)	*100%*	–
Next ten cases (Win)	*50%*	–
Lose (Low damages)	*40%*	*1,20,000*
Lose (High damages)	*10%*	*2,00,000*
Remaining five cases		
Win	*50%*	–
Lose (Low damages)	*30%*	*1,00,000*
Lose (High damages)	*20%*	*2,10,000*

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

Solution

According to AS 29 (Revised) 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

(i) There is a present obligation arising out of past events but not recognized as provision.

(ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(iii) The possibility of an outflow of resources embodying economic benefits is not remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 50% and for remaining five cases is 50%. As per AS 29 (Revised), we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases	= 40% of ₹ 1,20,000 + 10% of ₹ 2,00,000
	= ₹ 48,000 + ₹ 20,000 = ₹ 68,000
Expected loss in remaining five cases	= 30% of ₹ 1,00,000 + 20% of ₹ 2,10,000
	= ₹ 30,000 + ₹ 42,000 = ₹ 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 10,40,000 (₹ 68,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Illustration 2

EXOX Ltd. is in the process of finalising its accounts for the year ended 31st March, 20X2. The company seeks your advice on the following:

(i) The Company's sales tax assessment for assessment year 20X1-X2 has been completed on 14th February, 20X4 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

(ii) The Company has entered into a wage agreement in May, 20X2 whereby the labour union has accepted a revision in wage from June, 20X1. The agreement provided that the hike till May, 20X2 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 20X2.

Solution

(i) Since the company is not appealing against the addition of ₹ 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 20X4. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed as a contingent liability of ₹ 2.10 crore.

(ii) The arrears for the period from June, 20X1 to March, 20X2 are required to be provided for in the accounts of the company for the year ended on 31st March, 20X2.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Which of the following best describes a provision?*

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

   (b) *A provision is a possible obligation of uncertain timing.*

   (c) *A provision is a credit balance set up to offset a contingent asset so that the effect on the statement of financial position is nil.*

   (d) *A provision is a possible obligation of uncertain amount.*

2. *X Co is a business that sells second hand cars. If a car develops a fault within 30 days of the sale, X Co will repair it free of charge. At 1st March 20X1, X Co had made a provision for repairs of ₹ 25,000. At 31st March 20X1, X Co calculated that the provision should be ₹ 20,000. What entry should be made for the provision in X Co's income statement for the month 31st March 20X1?*

   (a) *A charge of ₹ 5,000*

   (b) *A credit of ₹ 5,000*

   (c) *A charge of ₹ 20,000*

   (d) *A credit of ₹ 25,000*

3. *Which of the following item does the statement below describe?*

   "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 entity's control"

   (a) *A provision*

   (b) *A current liability*

   (c) *A contingent liability*

   (d) *Deferred tax liability*

4. *Z Ltd has commenced a legal action against Y Ltd claiming substantial damages for supply of a faulty product. The lawyers of Y Ltd have advised that the company is likely to lose the case, although the chances of paying the claim is not remote. The estimated potential liability estimated by the lawyers are:*

Legal cost (to be incurred irrespective of the outcome of the case) ₹ 50,000

Settlement if the claim is required to be paid ₹ 5,00,000

What is the appropriate accounting treatment in the books of Z Ltd.?

(a) Create a Provision of ₹ 5,50,000

(b) Make a Disclosure of a contingent liability of ₹ 5,50,000

(c) Create a Provision of ₹ 50,000 and make a disclosure of contingent liability of ₹ 5,00,000

(d) Create a Provision of ₹ 5,00,000

Theoretical Questions

5. *When should provision be recognized as per provisions of AS 29? Explain in brief.*

Scenario based Questions

6. *Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 20X1-20X2 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 20X2-20X3 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 20X1-20X2 financial year. As on balance sheet date (31.3.20X2), the goods were not manufactured, and it was unlikely that Sun Ltd. will be able to meet the contractual obligation.*

   (i) Should Sun Ltd. provide for contingency as per AS 29?

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

7. *An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31st March 20X1, it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary?*

8. *A Ltd. provides after sales warranty for two years to its customers. Based on past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period.*

Less than 1 year: 2% provision

More than 1 year: 3% provision

The company has raised invoices as under :

Invoice Date	***Amount (₹)***
11th Feb, 20X0	*60,000*
25th Dec, 20X0	*40,000*
04th Oct, 20X1	*1,35,000*

Calculate the provision to be made for warranty under AS-29 as at 31st March, 20X1 and 31st March, 20X2. Also compute amount to be debited to P & L account for the year ended 31st March, 20X2.

ANSWERS/SOLUTIONS

Answer to the Multiple Choice Questions

1.	(a)	**2.**	(b)	**3.**	(c)	**4.**	(c)

Answer to the Theoretical Questions

5. A provision should be recognised only when: (a) An enterprise has a present obligation 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.

Answer to the Scenario based Questions

6. (i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognized. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting ₹ 1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 20X2 and no profit had accrued for the financial year 20X1-20X2. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.50 crores.

7. As per para 29 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a past event will lead to present obligation when the enterprise has no realistic alternative to settle the obligation created by the past event.

However, when environmental damage is caused, there may be no obligation to remedy the consequences. The causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

In the given case it is virtually certain that law will be enacted requiring clean-up of a land already contaminated. Therefore, an oil company has to provide for such clean-up cost in the year in which the law is virtually certain to be enacted.

8. Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

As at 31st March, 20X1 = ₹ 60,000 x .02 + ₹ 40,000 x .03

= ₹ 1,200 + ₹ 1,200 = ₹ 2,400

As at 31st March, 20X2 = ₹ 40,000 x .02 + ₹ 1,35,000 x .03

= ₹ 800 + ₹ 4,050 = ₹ 4,850

Amount debited to Profit and Loss Account for year ended 31st March, 20X2

	₹
Balance of provision required as on 31.03.20X2	4,850
Less: Opening Balance as on 1.4.20X1	(2,400)
Amount debited to profit and loss account	2,450

Note: No provision will be made on 31st March, 20X2 in respect of sales amounting ₹ 60,000 made on 11th February, 20X0 as the warranty period of 2 years has already expired.