# Creation and utilisation of a contingency reserve

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

EXPERT ADVISORY COMMITEE

## Facts of the case

1. A listed public sector company is engaged in refining of crude oil for production of various petroleum products. The petroleum sector is one of the largest contributors to the central and state exchequer in terms of various taxes and duties. There are a large number of issues related to tax, which are under various stages of litigation at different levels.

2. As per the accounting policy followed by the company, contingent liabilities in respect of show-cause notices issued by various government authorities are disclosed only in respect of those demands against which the company has appealed or decided to appeal. The aggregate of such contingent liabilities in the books as on 31st March 2004, is Rs 1,039 million.

3. The querist has stated that Indian refineries are required to pay international prices for crude oil and are entitled to receive from oil marketing companies, international prices for its products. The refining margins, i.e., the difference between crude oil and product prices, world over, have been ruling at fairly high levels in the past two years, resulting in more than normal profits to the company.

4. As per the accounting policy followed by the company, it would not be necessary to create provision for liabilities in respect of items included under contingent liabilities. However, as per the querist, in line with the requirements of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute of Chartered Accountants of India, the company has reviewed the items of contingent liabilities with a view to ascertain whether a provision is required and where required, a suitable provision will be created.

5. According to the querist, AS 29 requires creation of provision, if and only if, the liability is probable and not otherwise and accordingly, no provision, even if it is named as contingency provision, can be made for the contingent liabilities, which do not warrant any provision. In view of the fact that there are a number of disputes involving large sums of money required to be shown as contingent liabilities and a number of cases where show cause notices have been issued/likely to be issued, as a measure of prudence, the company desires to create a contingency reserve, as an appropriation of profits, so as to meet any eventuality that may arise in the future.

## Query

6. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) Whether the creation of a contingency reserve is permissible, as an appropriation in the profit and loss account?

(b) Whether it is necessary to establish any linkage with any specific item of contingent liability for creation of such a reserve?

(c) Whether it will be necessary to establish a pattern for creation of such a reserve from year to year or whether this can be created as a one-time measure based on the management's discretion?

(d) Whether it is permissible to utilise the reserve in the event of crystallisation of any contingency, without routing the same through profit and loss account?

## Points considered by the committee

7. The committee observes that the basic issue raised in the query relates to the creation of a contingency reserve, as an appropriation in the profit and loss account and utilisation thereof. In view of this, the committee has considered only this issue and has not touched upon any other issue, which may arise from the facts of the case such as whether show-cause notices should be disclosed as contingent liabilities.

8. The committee notes the definitions of the terms 'provision', 'liability', 'contingent liability' and 'present obligation' provided by AS 29, which are as follows:

"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."

"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."

"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."

9. The committee also notes paragraphs 14 and 68 of AS 29 which, inter alia, state as follows:

"14. 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."

"68. 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, measured under paragraphs 35-45;

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

(c) The possibility of any reimbursement."

10. The committee also notes the following definition of the term 'reserve' as given in the 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India:

"The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. The reserves are primarily of two types: capital reserves and revenue reserves."

11. The committee further notes paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items

and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India, which provides as below:

"5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."

12. On the basis of the definitions of the terms 'provision', 'liability', 'contingent liability' and 'present obligation' and other paragraphs of AS 29 reproduced above, the Committee is of the view that in case the requirements of AS 29 with regard to recognition of a provision or disclosure of a contingent liability are not met, the same are not required to be recognised/disclosed. With regard to creation of a contingency reserve to meet certain contingencies as an appropriation of profit, from the accounting standpoint, there is no bar on the management. Thus, the management of a company can transfer a part of the profits to a reserve at its discretion subject to the relevant statutory requirements such as Transfer of Profits to Reserves Rules, 1975. However, in the view of requirements of AS 5 reproduced above, on the crystallisation of a liability on account of an expense, the amount in this regard cannot be adjusted directly against the reserve. It has to be first recognised in the profit and loss account as a charge for determination of the profit of the relevant year. The management may transfer a corresponding amount from the contingency reserve to the general reserve. The committee is of the view that in case an expense or a provision is permitted to be adjusted against reserve directly, the relevant expense or provision would never be recognised in the profit and loss account, which is not as per the generally accepted accounting principles.

### Opinion

13. On the basis of the above, the committee is of the following opinion on the issues raised in paragraph 6 above:

(a) Contingency reserve can be created as an appropriation in the profit and loss account.

(b) It is not necessary to establish any linkage with any specific item of contingency for creation of a contingency reserve.

(c) From an accounting standpoint, there is no necessity to establish any kind of pattern for creation of such a reserve from year to year. Creation of a reserve is a discretion of management and, therefore, can be a one-time measure.

(d) In the event of crystallisation of any liability on account of an expense, the same has to be routed through the profit and loss account by way of a charge thereto. Accordingly, it is not permissible to utilise the reserve directly. ❐