# Whether provision can be made for a possible future obligation

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

## *A. Facts of the Case*

1 A company has been incorporated under section 25 of the Companies Act, 1956. The main objective of the company is to promote India's trade. One of the medium of promoting the trade is organising trade fairs and exhibitions in various parts of the country. The fairs/exhibitions organised by the company and also by outside agencies attract large crowds besides the exhibitors.

2 The querist has informed that from the year 2000-01, it was decided to charge 5 per cent contingency charges from the participants/outside agencies on the income received from them by the company. While in the case of fairs organised by outside agencies, the 5 per cent contingency charges are levied separately in the invoice, the contingency charges in respect of fairs organised by the company itself are inbuilt in the space rent charged from the participants. Both are credited to the Income and Expenditure Account of the company. The intention of levying these charges is to meet any unforeseen liability which may arise in future. The instances of such unforeseen liabilities could be on account of injury/loss of life of visitors/exhibitors etc., due to fire, terrorist attack, stampede, electrocution, natural calamites and other public/third party liability, statutory liabilities, etc. The chances of occurrence of these events are high because large crowds visit the fairs/exhibitions. Besides, the likelihood of damage to the participant's exhibits due to any of the reasons indicated also exists.

*1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.*

*2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 22 volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.*

3 The querist has mentioned that, as a prudent policy, a matching provision for the same is also being made in the accounts to reflect a true and fair view of the state of affairs of the company. A suitable disclosure to this effect is also made in the notes forming part of accounts. The decision to levy the 5 per cent contingency charges was based on an assessment only, as the actual liability on this account cannot be estimated.

4 During the audit of the accounts for the year 2002-03, the statutory auditors of the company felt that provision against unknown liabilities and the expenses of contingent nature, which are contingent/unkown, is violative of the provisions of the Companies Act, 1956. In other words, the statutory auditors were of the view that no liability can be provided in the books of account unless the quantum of the liability and the details of the payee are known.

5 The querist has drawn the attention of the Committee to Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India, wherein the term 'Contingency' has been defined as "a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events." In the view of the querist, some events may occur in future which may affect the profitability of the company and, as a safeguard, a provision to meet unforeseen liability can be made in the books of account. The company's contention that the matching provision is being made against the amounts being recovered to discharge any future liability, which may or may not occur, was however not accepted by the auditors and the accounts of the organisation were qualified by the statutory auditors on this aspect.

## B. Query

6 The querist has sought the opinion of the Expert Advisory Committee as to whether creation of provision for contingencies under the facts and circumstances of the case is in conformity with AS 4.

## C. Points considered by the Committee

7 The Committee notes that as far as accounting for contingencies is concerned, Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India, is mandatory in respect of accounting periods commencing before 1-4-2004 and Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets' is mandatory in respect of accounting periods commencing on or after 1-4-2004. In the present case, AS 4 is applicable to the company as query relates to accounting period commencing before 1-4-2004.

8 The Committee notes that the term 'Contingency' has been defined in AS 4 as reproduced in paragraph 5 above. The Committee further notes paragraphs 4.1, 5.6 and 10 of AS 4, which are reproduced below:

> "4.1 The term "contingencies" used in this Statement is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur."
>
> "5.6 Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date."
>
> ***"10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:***
>
> ***(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and***
>
> ***(b) a reasonable estimate of the amount of the resulting loss can be made."***

9 On the basis of the above paragraph, the Committee is of the view that in respect of contingencies against which provision is being created by the company, no condition or situation exists on the balance sheet date. Accordingly, it cannot be considered probable that future events will confirm that a liability has been incurred as at the balance sheet date. In view of this, the Committee is of the view that the provision for contingencies cannot be created irrespective of the fact that a charge in this regard is made from its customers.

10 The Committee also notes paragraph 14 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', which is reproduced below:

> ***"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."***

11 From the above paragraph, the Committee notes that in respect of the contingencies considered by the company neither a present obligation exists as a result of past event, nor a reliable estimate can be made of the amount of the obligation. Accordingly, a provision cannot be recognised for contingencies under the facts and circumstances stated by the querist.

12 The Committee notes that Part III of Schedule VI to the Companies Act, 1956, *inter alia*, provides the following:

> "7. (1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires, –
>
> (a) the expression "provision" shall, subject to

sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability, of which the amount cannot be determined with substantial accuracy;

(2) Where –

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(b) any amount retained by way of providing for any known liability,

is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision."

13 On the basis of the above paragraph, the Committee is of the view that since the contingencies stipulated by the company are not known at the balance sheet date, the provision in this regard cannot be created. Accordingly, the provision for contingencies created by the company is of the nature of a reserve.

## D. Opinion

14 On the basis of the conclusions drawn in paragraphs 9, 11 and 13 above, the Committee is of the opinion that, under the facts and circumstances of the case, creation of the provision for contingencies is not in conformity with AS 4 and AS 29 issued by the Institute of Chartered Accountants of India and Schedule VI to the Companies Act, 1956.