

Exposure Draft

Proposed Accounting Standard

Provisions, Contingent Liabilities and Contingent Assets

The following is the text of the Exposure Draft of proposed Accounting Standard on 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Accounting Standards Board of the Institute of Chartered Accountants of India for comments. Members and others are requested to send their comments on the Exposure Draft to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than **June 16, 2003**. Comments can also be sent by e-mail at tdte@icai.org.

(In this Exposure Draft, the standard portions have been set in bold italic type. These should be read in the context of the background material, which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards'¹.)

This Accounting Standard will come into effect in respect of accounting periods commencing on or after (date to be decided later) and will be mandatory in nature² from that date.

From the date of this Accounting Standard becoming mandatory, all paragraphs of Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1 (a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16), stand withdrawn.

Objective

The objective of this Statement is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial state-

ments to enable users to understand their nature and amount. This Statement also deals with contingent assets.

Scope

1. ***This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:***
 - (a) *those resulting from financial instruments³ that are carried at fair value;*
 - (b) *those resulting from executory contracts;*
 - (c) *those arising in insurance enterprises from contracts with policy-holders; and*
 - (d) *those covered by another Accounting Standard.*
2. This Statement applies to financial instruments (including guarantees) that are not carried at fair value.
3. 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.
4. This Statement applies to provisions, contingent liabilities

¹ Attention is specifically drawn to paragraph 4.3 of the Preface, according to which accounting standards are intended to apply only to material items.

² This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

³ For the purpose of this Statement, the term 'financial instruments' shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.

ties and contingent assets of insurance enterprises other than those arising from contracts with policy-holders.

5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement. For example, certain types of provisions are also addressed in Accounting Standards on:
 - (a) construction contracts (see AS 7, Accounting for Construction Contracts);
 - (b) taxes on income (see AS 22, Accounting for Taxes on Income);
 - (c) leases (see AS 19, Leases); and
 - (d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).
6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Statement does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Statement does not change the requirements of AS 9.
7. This Statement defines provisions as liabilities which can be measured only by using a substantial degree of estimation. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Statement.
8. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Statement. Accordingly, this Statement neither prohibits nor requires capitalisation of the costs recognised when a provision is made.
9. This Statement applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a discontinuing operation, additional disclosures are required by AS 24, Discontinuing Operations.

Definitions

10. *The following terms are used in this Statement with the meanings specified:*

*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.*

11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.
12. Provisions can be distinguished from other liabilities such as trade payables because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement.
13. In this Statement, the term 'contingent' is used for liabilities and assets that are not recognised because their

existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

Recognition

Provisions

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.

Present Obligation

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of 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 (see paragraph 69).

Past Event

16. 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.

- 17. 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.
- 18. 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.
- 19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed- indeed the obligation may be to the public at large.
- 20. 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.
- 21. 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. Differences in circumstances surrounding enactment usually make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable Outflow of Resources Embodying Economic Benefits

22. 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 this Statement⁴, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 69).
23. 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 recognised (if the other recognition criteria are met).

Reliable Estimate of the Obligation

24. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature involve a greater degree of estimation than most other items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is reliable to use in recognising a provision.
25. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 69).

Contingent Liabilities

26. *An enterprise should not recognise a contingent liability.*
27. A contingent liability is disclosed, as required by paragraph 69, unless the possibility of an outflow of

resources embodying economic benefits is remote.

28. 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 recognises 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 (see paragraph 14).
29. 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 recognised in accordance with paragraph 14 in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

Contingent Assets

30. *An enterprise should not recognise a contingent asset.*

31. 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.
32. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
33. 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.
34. 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 recognised in the financial statements of the period in which the change occurs.

⁴ The interpretation of 'probable' in this Statement as 'more likely than not' does not necessarily apply in other Accounting Standards.

Measurement

Best Estimate

35. *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 amount of a provision should not be discounted to its present value.*
36. The best estimate of the expenditure required to settle the present obligation is the amount that an enterprise would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the balance sheet date. However, the estimate of the amount that an enterprise would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the balance sheet date.
37. 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 evidence considered includes any additional evidence provided by events after the balance sheet date.
38. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22, Accounting for Taxes on Income.

Risks and Uncertainties

39. *The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.*
40. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid

duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

41. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 68(b).

Future Events

42. *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.*
43. Expected future events may be particularly important in measuring provisions. 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 recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.
44. 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.

Expected Disposal of Assets

45. *Gains from the expected disposal of assets should not be taken into account in measuring a provision.*
46. 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 recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

47. *Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.*
48. *In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.*
49. Sometimes, an enterprise is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the enterprise or pay the amounts directly.
50. 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 recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.
51. 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.
52. As noted in paragraph 28, an obligation for which an enterprise is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

53. *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.

Use of Provisions

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

Application of the Recognition and Measurement Rules

Future Operating Losses

56. *Provisions should not be recognised for future operating losses.*
57. Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.
58. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An enterprise tests these assets for impairment under Accounting Standard (AS) 28, Impairment of Assets.

Restructuring

59. The following are examples of events that may fall under the definition of restructuring:
- sale or termination of a line of business;
 - the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
 - changes in management structure, for example, eliminating a layer of management; and
 - fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.
60. A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in paragraph 14 are met.
61. *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.*
62. An enterprise cannot be committed to the sale until

a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the 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. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Accounting Standard (AS) 28, Impairment of Assets.

63. *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.*

64. 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 recognised on the same basis as if they arose independently of a restructuring.

65. Identifiable future operating losses up to the date of a restructuring are not included in a provision.

66. As required by paragraph 45, 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.

Disclosure

67. *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.*

68. *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, as addressed in paragraph 42; and*

(c) *the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.*

69. *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 35-46;*

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

(c) *the possibility of any reimbursement.*

70. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 68 (a) and (b) and 69 (a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

71. Where a provision and a contingent liability arise from the same set of circumstances, an enterprise makes the disclosures required by paragraphs 67-69 in a way that shows the link between the provision and the contingent liability.

72. *Where any of the information required by paragraph 69 is not disclosed because it is not practicable to do so, that fact should be stated.*

73. *In extremely rare cases, disclosure of some or all of the information required by paragraphs 67-71 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.*

Appendix A

Tables - Provisions, Contingent Liabilities, Contingent Assets and Reimbursements

The purpose of this appendix is to summarise the main requirements of the Accounting Standard. It does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.

Provisions and Contingent Liabilities

<p>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.</p>		
<p>There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.</p>	<p>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.</p>	<p>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</p>
<p>A provision is recognised (paragraph 14).</p> <p>Disclosures are required for the provision (paragraphs 67 and 68)</p>	<p>No provision is recognised (paragraph 26).</p> <p>Disclosures are required for the contingent liability (paragraph 69).</p>	<p>No provision is recognised (paragraph 26).</p> <p>No disclosure is required (paragraph 69).</p>

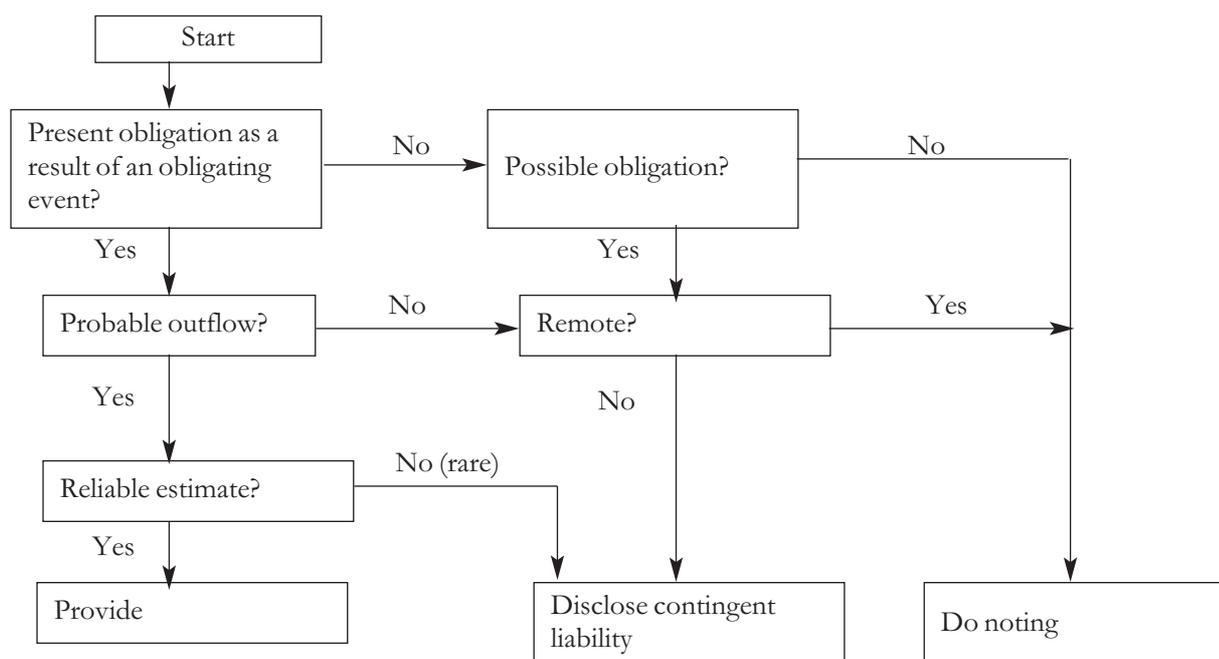
Reimbursements

<p>Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.</p>		
<p>The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.</p>	<p>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.</p>	<p>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.</p>
<p>The enterprise has no liability for the amount to be reimbursed (paragraph 51).</p> <p>No disclosure is required.</p>	<p>The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 47 and 48).</p> <p>The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 68(c)).</p>	<p>The expected reimbursement is not recognised as an asset (paragraph 47).</p> <p>The expected reimbursement is disclosed (paragraph 68(c)).</p>

Appendix B

Decision Tree

The purpose of the decision tree is to summarise the main recognition requirements of the Accounting Standard for provisions and contingent liabilities. The decision tree does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (paragraph 15 of the Standard).

Appendix C

Examples: Recognition

This appendix illustrates the application of the Accounting Standard to assist in clarifying its meaning. It does not form part of the Accounting Standard.

All the enterprises in the examples have 31 December year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the examples.

The cross references provided in the examples indicate paragraphs of the Accounting Standard that are particularly relevant. The appendix should be read in the context of the full text of the Accounting Standard.

Example 1: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

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

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 23).

Example 2: Contaminated Land - Legislation Virtually Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 December 2002 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

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

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

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 21).

Example 3: Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

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

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Example 4: Refunds Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of refunds (see paragraphs 11, 14, and 23).

Example 5: Legal Requirement to Fit Smoke Filters

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 June 2003. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 December 2002

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14 and 16-18).

(b) At the balance sheet date of 31 December 2003

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

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

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 16-18).

Example 6: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

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

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

Example 7: A Single Guarantee

During 2002, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2003, the financial condition of Enterprise B deteriorates and at 30 June 2003 Enterprise B goes into liquidation.

(a) At 31 December 2002

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

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 December 2002.

Conclusion - No provision is recognised (see paragraphs 14 and 22). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraph 69).

(b) At 31 December 2003

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

An outflow of resources embodying economic benefits in settlement - At 31 December 2003, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation (see paragraphs 14 and 22).

Note: This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable (see paragraph 23). Where an enterprise gives guarantees in exchange for a fee, revenue is recognised under AS 9, Revenue Recognition.

Example 8: A Court Case

After a wedding in 2002, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 December 2002, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 December 2003, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 December 2002

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

Conclusion - No provision is recognised (see definition of 'present obligation' and paragraph 15). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 69).

(b) At 31 December 2003

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

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

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-15).

Example 9: Refurbishment Costs - No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

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

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e., it is depreciated over five years. The re-lining costs then incurred are capitalized with the consumption of each new lining shown by depreciation over the subsequent five years. In other words, lining is considered as a separate asset with an independent estimate of useful life.

Appendix D

Example: Disclosures

The appendix is illustrative only and does not form part of the Accounting Standard. The purpose of the appendix is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

An example of the disclosures required by paragraph 68 is provided below.

Example 1 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a provision of Rs. 60,000 has been recognised. The following information is disclosed:

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

An example is given below of the disclosures required by paragraph 73 where some of the information required is not given because it can be expected to prejudice seriously the position of the enterprise.

Example 2 Disclosure Exemption

An enterprise is involved in a dispute with a competitor, who is alleging that the enterprise has infringed patents and is seeking damages of Rs. 1000 lakhs. The enterprise recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 67 and 68 of the Statement. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of Rs. 1000 lakhs. The information usually required by AS ____, Provisions, Contingent Liabilities and Contingent Assets is not disclosed on the grounds that it can be expected to prejudice the interests of the company. The directors are of the opinion that the claim can be successfully resisted by the company.

Appendix E

Note: This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard ____ and corresponding International Accounting Standard (IAS) 37.

Comparison with IAS 37, Provisions, Contingent Liabilities and Contingent Assets (1998)

The Draft Accounting Standard differs from International Accounting Standard (IAS) 37, Provisions, Contingent Liabilities and Contingent Assets, in the following major respects:

1. Discounting of Provisions

IAS 37 requires that where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation. On the other hand, the Draft Accounting Standard requires that the amount of a provision should not be discounted to its present value. The Board is of the view that discounting should not be required because, at present, in India, financial statements are prepared generally on historical cost basis and not on present value basis.

2. Accruals and Provisions

IAS 37 adopts a three way classification, i.e., trade

payables, accruals and provisions. The Board is of the view that no distinction should be made between accruals and provisions because, in some cases, distinction between accruals and provisions may be a matter of considerable debate and subjective judgement. Further, distinction between accruals and provisions under IAS 37 is relevant as discounting is required in case of provisions, where the effect of the time value of money is material, whereas discounting is not required in case of accruals. However, keeping in view the proposal in the Draft Accounting Standard that discounting of provisions should not be required, making distinction between accruals and provisions will not serve any useful purpose. Accordingly, the relevant provisions of IAS 37 have not been included in the Draft Accounting Standard.

3. Onerous Contracts

IAS 37 requires that if an enterprise has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision. For this purpose, IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

The Board is of the view that in respect of onerous contracts, on which IAS 37 is applicable, present obligation should not be required to be recognised. This is because recognition of estimated loss in case of an onerous contract amounts to recognition of loss of future periods in the current year's profit and loss account thereby distorting the operating results of the current year. Further, it may not be feasible to determine, in all cases, whether a particular contract is onerous or not because which costs are unavoidable may be a matter of subjective judgement. Accordingly, the provisions of IAS 37 relating to onerous contracts including the definition of 'onerous contract' have been omitted from the Draft Accounting Standard.

4. Constructive obligation and Restructurings

IAS 37 deals with 'constructive obligation' in the context of creation of a provision. The effect of recognising provision on the basis of constructive obligation is that, in some cases, provision will be required to be recognised at an early stage. For example, in case of a restructuring, a constructive obligation arises when an enterprise has a detailed formal plan for the restructuring and the enter-

prise has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. The Board is of the view that merely on the basis of a detailed formal plan and announcement thereof, it would not be appropriate to recognise a provision since a liability can not be considered to be crystallised at this stage. Further, the judgment whether the management has raised valid expectations in those affected may be a matter of considerable argument.

In view of the above, the Draft Accounting Standard does not deal with 'constructive obligation'. Thus, in situations such as restructuring, general recognition criteria are required to be applied.

5. Statistical methods for measurement of provisions

IAS 37 provides certain statistical methods for measurement of provisions. Draft Accounting Standard does not deal with statistical methods to measure the amount of the provision because the Board is of the view that measurement of a provision depends on the estimates of the management and method to be followed in this regard would depend on the nature of provision. It is felt that restricting the measurement of provisions to only certain statistical methods would not be appropriate.

6. Contingent Assets

Both the Draft Accounting Standard and IAS 37 require that an enterprise should not recognise a contingent asset. However, IAS 37 requires certain disclosures in respect of contingent assets in the financial statements where an inflow of economic benefits is probable. In contrast to this, as a measure of prudence, the Draft Accounting Standard does not even require contingent assets to be disclosed in the financial statements. The Draft recognises that contingent asset is usually disclosed in the report of the approving authority where an inflow of economic benefits is probable.

7. Definitions

In the Draft Accounting Standard, the definitions of the terms 'present obligation' and 'possible obligation' have been added as compared to IAS 37 with a view to bring more clarity. Some other definitions contained in IAS 37 have been omitted/modified as a consequence to departures from IAS 37.