

Presentation of Write-Back of Provisions No Longer Required in the Statement of Profit And Loss

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

A. Facts of the Case

1. A public sector company under the Ministry of Steel, Government of India, is primarily engaged in rendering design & engineering, technical consultancy, and project management services etc. for various clients in India and abroad. The company is also executing Engineering, Procurement and Construction (EPC)/turnkey projects involving supply of equipment, erection, commissioning etc. for various clients/projects. As a part of financial and business restructuring, the core business activities of the company have been divided into four Strategic Business Units (SBUs), namely metal, power, oil & gas and infrastructure. These four segments have been disclosed as primary business segments as per the requirements of Accounting Standard (AS) 17, 'Segment Reporting'. The primary objectives of these SBUs are to focus on procurement and execution of jobs in the above fields. The nature of activities of the company is diverse and flexible depending upon various factors like global business scenario, economic policy of the Government, investment decision, and corporate strategy.
2. The querist has stated that as per revised Schedule VI to the Companies Act, 1956, in the statement of profit and loss, total revenue is divided under two heads, i.e., 'Revenue from Operations' and 'Other Income'. In respect of a company other than a finance company, revenue from operations is sub-divided into three heads namely sale of products, sale of services and other operating revenue. Other income is sub-divided into interest income, dividend income, net gain/loss on sale of investment and other non-operating income. It is important to understand the meaning of the term 'other operating revenue' and which items should be classified under this head *vis-a-vis* under the head 'other income'. The Guidance Note on the Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India (ICAI), inter alia, states that the term 'other operating revenue' is not defined. However,

these include revenues arising from the company's operating activities. Whether a particular income constitutes 'other operating revenue' or 'other income' is to be decided based on the facts of each case and detailed understanding of the company's activities (emphasis supplied by the querist).

3. The querist has also reproduced the relevant extracts of accounting policy of the company as follows (refer Note 32 of the financial statements of the company for the year 2012-13):

"Use of Estimates

In preparing the financial statements in conformity with accounting principles generally accepted in India, the company makes best estimates and assumptions that may affect the reported amount of assets and liabilities and the disclosure of contingent liabilities as at the reporting date and the amount of revenue and expenses during the reporting period. Actual result in some cases may differ from those estimates. Any revision of such estimates is recognised during the period in which the same is determined."

"Provision for Contractual Obligations/LD, etc.

- (i) Provisions for estimated liabilities on account of guarantees & warranties etc. in respect of Engineering & Consultancy Services and Turnkey Contracts are made by the company after assessment of risk and consequential probable liabilities on case to case basis.
- (ii) Provisions for liquidated damages are made as and when these are deducted and/or considered deductible by the client as per contract.
- (iii) Suppliers'/contractors' claims for price escalation, additional or extra claims, etc. are accounted for to the extent such claims are accepted by the company."

4. Accounting treatment/ practice followed by the company has been stated by the querist as follows:
 - Each and every job being distinct and

different in nature is allotted a specific work item number (chargeable) from the date of commencement of job. Each and every job being executed for client is part and parcel of the company's operating activities and source of revenue. The company has divided revenue from operations into three items namely revenue from consultancy services, revenue from construction contracts and other operating revenues (refer Note 23). Revenue from consultancy services and revenue from construction contracts are recognised as per the accounting policy of the company. In the course of execution of jobs/operating activities of the company, the company is making various provisions for expenditures out of contractual obligations as per the requirement of contracts with various sub-contractors/vendors/clients *etc.* Further, the company is also making provisions as per the requirement of applicable Accounting Standards /accounting practices as the case may be.

- Broadly, the company has classified the expenditure as 'operating expenditure' and 'non-operating expenditure'. Accordingly, expenses incurred in relation to work items (chargeable) are treated as operating expenses and expenses incurred not in relation to any work item (chargeable) are treated as non-operating expenses keeping in mind the nature of activities of the company. However, the revised Schedule VI has not categorically classified any expenditure as either 'operating expenditure' or 'non-operating expenditure'.
- Provisions for contractual obligations/expenses and other provisions, which are related to work items (chargeable) and which are related to operating activities, are part of operating expenses (Refer Note 25 and Note 30 of the financial statements of the company for the financial year (F.Y.) 2012-13). Provisions for contractual obligations/expenses, provisions for bad & doubtful debts, provisions for liquidated damages recovered by clients, provisions for claims recoverable from clients, provisions for advances recoverable from clients *etc.*, which are related to work items (chargeable) and which are related to operating activities, are reviewed periodically and reversed in the
- accounts on case to case basis as and when these provisions are no longer required to be carried in the balance sheet. Therefore, such provisions no longer required and written back which are related to work items and related to operating activities are treated as part of 'other operating revenues' considering the nature of activities of the company and also in the ordinary course of business of the company. For instance, trade receivable is essentially recognised as amount to be realised from goods sold or services provided to the particular client in the normal course of operation. Hence, writing back of provision against trade receivable with specific work item number is also shown as 'other operating revenues'. Considering the nature of activities/business profile of the company, same logic is applied for similar items of provisions written back which are related to work items and related to operating activities and, therefore, are shown under 'other operating revenues' as a matter of prudent accounting practice consistently followed by the company.
- Provisions for salary and wages, provision for employee related expenses, provision for various administrative and office expenses of general nature which are not related to any work item (chargeable) are treated as non-operating expenses (Refer Note 27 and Note 30). Such provisions which are not related to work items (chargeable) are reviewed periodically and reversed in the accounts on case to case basis as and when these provisions are no longer required to be carried in the balance sheet. Therefore, such provisions no longer required and written back which are not related to work items are shown as 'other non-operating income' under the head 'other income' (refer Note 24) as a matter of prudent accounting practice consistently followed by the company.
- As per the annual accounts of the company, Note 25 'Purchase of Equipments and Direct Expenses' represent operating expenses only, Note 27 'Employee Benefit Expenses' represent non-operating expenses only and Note 30 'Other Expenses' represent operating expenses and non-operating expenses both. As per Note 30, provision for bad & doubtful

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- debts, provision for liquidated damages recovered by clients, provision for claims recoverable from clients, provision for advances recoverable from clients, provision for doubtful deposits *etc.* which are related to work items (chargeable) and related to operating activities of the company are items of operating expenses. On the other hand, rent, rates & taxes, repairs & maintenance, audit fees, advertisement & publicity, legal & professional fees, postage & telephone, power & fuel *etc.* which are not related to any work item (chargeable) are items of non-operating expenses.
- To sum up, in compliance with the requirements of revised Schedule VI, provisions written back related to work items (chargeable) are shown as 'other operating revenues' under the head 'revenue from operations' and provisions written back not related to work items (chargeable) are shown as 'other non-operating income' under the head 'other income' in the statement of profit and loss as a matter of prudent accounting practice consistently followed by the company.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee of the ICAI on the following issues:
 - (i) Considering the nature of activities of the company, whether the company is correct to present and disclose provisions no longer required and written back which are related to work item numbers (chargeable) and related to operating activities as 'other operating revenues' under the head 'revenue from operations'.
 - (ii) Considering the nature of activities of the company whether the company is correct to present and disclose provisions no longer required and written back which are not related to work item numbers as 'other non-operating income' under the head 'other income'.
 - (iii) Whether the company can continue to follow the above accounting treatment and the above presentation and disclosure as required under revised Schedule VI to the Companies Act, 1956 or Schedule III to the Companies Act, 2013 as applicable.

- (iv) If not, what alternative accounting entry should be passed in the accounts and what presentation and disclosure should be made by the company as required under the Companies Act and Accounting Standards as applicable.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to the presentation and disclosure of write back of provisions no longer required in the financial statements. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of classification of expenses including provisions into operating and non-operating, whether accounting policies of the company with regard to use of estimates and recognition of provisions are in conformity with Accounting Standards, *etc.* The Committee while expressing its opinion has dealt only with the broad principles regarding presentation of write back of provisions and has not gone into the presentation of each provision being recognised by the company.
7. The Committee notes the following paragraphs of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets' and Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies':

AS 29

"10.1 A provision is a liability which can be measured only by using a substantial degree of estimation."

“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. ..."

“Changes in Provisions

52. 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.”

AS 5

"Changes in Accounting Estimates

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item."

"25. The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

26. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item."

8. From the above, the Committee notes that the provisions are measured at the best estimate of the expenditure which may be required to settle the present obligation at the balance sheet date and the same should be reviewed at each balance sheet date and adjusted to reflect the current best estimates. Accordingly, any change in the amount of the provision including write-back of earlier provision no longer required is a change in estimate, which should be treated in accordance with the requirements of AS 5. With regard to classification of the effect of change in accounting estimates, AS 5 prescribes that the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss.
9. The Committee further notes that although revised Schedule VI to the Companies Act, 1956, requires incomes to be classified into operating and non-operating, such an explicit classification is not specified for expenses. Accordingly, the Committee is of the view that if the provision was earlier classified as 'other expense', the reversal should be classified as other operating income or non-operating income keeping in view the fact that whether the provision pertains to an item which is operating in nature or non-operating in nature considering the business and nature of the activities of the company.
10. With regard to the disclosure of write-back of the excess provisions no longer required,

Accordingly, in the extant case, the Committee is of the view that where, in an accounting period, there is any write-back of the earlier recognised provision for a liability and a provision for the same item is also being recognised in that accounting period, the write-back should be adjusted in arriving at the amount of that provision, i.e., only the net amount after adjustment of the write-back should be charged/credited to the statement of profit and loss. However, where, in an accounting period, there is only write-back of the earlier recognised provision and no provision is being recognised, the write-back should be recognised as income in the statement of profit and loss using the same classification as was used previously. For example, reversal on account of provision for warranties created during the earlier years is ₹20 and ₹100 is required for providing for warranties in respect of sales effected in the current year on account of provision for warranties. In such a case, write-back of ₹20 should be adjusted to ₹100 and ₹80 (₹100-₹20) should be recognised as provision for warranties in the statement of profit and loss for the current year. Where no provision is required to be recognised for the current year on account of provision for warranties, write-back of ₹20 should be recognised as income. The Committee notes from 'Note No. 36.9- Particulars of Provision' to the financial statements of the company for the F.Y. 2012-13 that in respect of provisions, for example, in respect of 'provision for claims recoverable', the company is not adjusting the write-back of provisions in the amount of provisions recognised in the statement of profit and loss for the current period. Accordingly, the Committee is of the view that the company's presentation policy to that extent is not correct.

9. The Committee further notes that although revised Schedule VI to the Companies Act, 1956, requires incomes to be classified into operating and non-operating, such an explicit classification is not specified for expenses. Accordingly, the Committee is of the view that if the provision was earlier classified as 'other expense', the reversal should be classified as other operating income or non-operating income keeping in view the fact that whether the provision pertains to an item which is operating in nature or non-operating in nature considering the business and nature of the activities of the company.
10. With regard to the disclosure of write-back of the excess provisions no longer required,

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the Committee notes the following paragraph of AS 29:

“Disclosure

66. *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.*
- ...”

The Committee further notes Clause (b) of Note 5(v) of the ‘General Instructions for Preparation of Statement of Profit and Loss’, of revised Schedule VI to the Companies Act, 1956, as well as, Schedule III to the Companies Act, 2013, which is reproduced as below:

“5. Additional Information

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

...

(v) (a) ...

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.”

On the basis of the above, the Committee notes that in addition to the presentation requirements discussed in paragraphs 8 and 9 above, the company should give disclosures as per paragraph 66 of AS 29 and above reproduced requirements of revised Schedule VI to the Companies Act, 1956, or Schedule III to the Companies Act, 2013, as applicable.

D. Opinion

11. The Committee is of the following opinion on the issues raised by the querist:

(i) & (ii) The Committee is of the view that where, in an accounting period, there is any write-back of the earlier recognised provision for a liability and a provision for the same item is also being recognised in that accounting period, the write-back should be adjusted in arriving at the amount of that provision, i.e., only the net amount after adjustment of the write-back should be charged/credited to the statement of profit and loss. However, where, in

an accounting period, there is only write-back of the earlier recognised provision and no provision is being recognised, the write-back should be recognised as income in the statement of profit and loss using the same classification as was used previously. Since the company is not adjusting the write-back of provisions in the amounts of provisions recognised in the statement of profit and loss for the F.Y. 2012-13, the company’s presentation policy to that extent is not correct. The Committee is further of the view that if the provision was earlier classified as ‘other expense’, the reversal should be classified as other operating income or non-operating income keeping in view the fact that whether the provision pertains to an item which is operating in nature or non-operating in nature considering the business and nature of the activities of the company.

(iii) & (iv) With regard to presentation of write-back of provisions no longer required, refer (i) & (ii) above. With regard to disclosure requirements in this regard, the company should give disclosures prescribed in AS 29 and revised Schedule VI to the Companies Act, 1956, or Schedule III to the Companies Act, 2013, as applicable, as mentioned in paragraph 10 above.

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 Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on May 1, 2014. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty two volumes. A CD of Compendium of Opinions containing thirty two volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head ‘Resources’.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head ‘Resources’. For further information, write to eac@icai.in .