Ind-AS 37
PROVISIONS, CONTINGENT LIABILITIES, AND CONTINGENT ASSETS
Prescribes rules regarding the recognition and measurement of Provisions, Contingent Liabilities, and Contingent Assets + Mandates Disclosures.

Also

Clarified certain misconceptions about the term “provision.” For instance, “provisions” that are envisioned by this Standard are now “liabilities” (of uncertain timing or amount). The “provision for depreciation” and the “provision for doubtful debts” - not provisions according but are contra accounts or adjustments to the carrying value of assets.
APPLICABILITY

• **APPLIED TO**
  - All Types of Provisions,
  - Contingent Liabilities and
  - Contingent Assets.

• **NOT APPLIED TO**
  - Executory contracts (Other than Onerous Contracts)
  - And covered by other standards
    - (Ind-AS 11, Ind-AS 12, Ind-AS 17)
    - (However, onerous leases are covered by Ind-AS 37.)
  - Employee benefits (Ind-AS 19)
  - Ind-AS 39, Ind-AS 104
• **Contingent asset.**
  A possible asset arising from past events and whose existence contingent on occurrence or nonoccurrence of one or more uncertain future events that are not completely within the control of the entity.

• **Executory contract.**
  A contract under which neither party (to the contract) has performed its obligations or both the parties (to the contract) have performed their obligations partially to an equal extent.

• **Onerous contract.** A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract.
Provision
• A Liability of Uncertain Timing or Amount

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

Existence contingent upon occurrence or non occurrence of future events

Which are not within the control of the Entity

Present Obligation

Not recognised – not reliably measure the obligation

It is not probable that an outflow of resources will be required to settle the obligation.

Both From Past Events
Those liabilities that are of uncertain timing or amount are “provisions,”

To Be Recognised IF & ONLY IF ALL THREE Conditions Are Met

(a) An entity has a present obligation resulting from a past event;

(b) It is probable that an outflow of resources embodying economic benefits would be required to settle the obligation; and

(c) A reliable estimate can be made of the amount of the obligation.
Probable that Outflow of Sources would Occur – More Likely Than NOT
Case Study 1

- **Facts**
  Excellent Inc. is an oil entity that is exploring oil off the shores of Excess oil Islands. It has employed oil exploration experts from around the globe. Despite all efforts, there is a major oil spill that has grabbed the attention of the media. Environmentalists are protesting and the entity has engaged lawyers to advise it about legal repercussions. In the past, other oil entities have had to settle with the environmentalists, paying huge amounts in out-of-court settlements. The legal counsel of Excellent Inc. has advised it that there is no law that would require it to pay anything for the oil spill; the parliament of Excess oil Islands is currently considering such legislation, but that legislation would probably take another year to be finalized as of the date of the oil spill. However, in its television advertisements and promotional brochures, Excellent Inc. often has clearly stated that it is very conscious of its responsibilities toward the environment and will make good any losses that may result from its exploration. This policy has been widely publicized, and the chief executive officer has acknowledged this policy in official meetings when members of the public raised questions to him on this issue.

- **Required**
  Does the above give rise to an obligating event that requires Excellent Inc. to make a provision for the cost of making good the oil spill?
Solution

• (a) Present obligation as a result of a past obligating event. The obligating event is the oil spill. Because there is no legislation in place yet that would make cleanup mandatory for any entity operating in Excessoil Islands, there is no legal obligation. However, the circumstances surrounding the issue clearly indicate that there is a constructive obligation since the company, with its advertised policy and public statements, has created an expectation in the minds of the public at large that it will honor its environmental obligations.

(b) An outflow of resources embodying economic benefits in settlement. Probable.

(c) Conclusion. A provision should be recognized for the best estimate of the cost to clean up the oil spill.
Gains from expected future disposals should not be considered.

However, if amounts are expected to be reimbursed by another party, these should be taken into consideration in arriving at the amount of the provision.

Only WHEN IT IS VIRTUALLY CERTAIN
Case Study 2

Facts

• A car dealership also owns a workshop that it uses for servicing cars under warranty. In preparing its financial statements, the car dealership needs to ascertain the provision of warranty that it would be required to provide at year-end. The entity’s past experience with warranty claims is
  • 60% of cars sold in a year have zero defects.
  • 25% of cars sold in a year have normal defects.
  • 15% of cars sold in a year have significant defects.

The cost of rectifying a “normal defect” in a car is $10,000. The cost of rectifying a “significant defect” in a car is $30,000.
Solution

The expected value of the provision for warranty needed at year-end is:

\[(60\% \times 0) + (25\% \times $10,000) + (15\% \times $30,000) = $7,000.\]

• Changes in provisions shall be reviewed
• at each balance sheet date, and
• the amount of the provision should be adjusted.
• If needed, provision should be reversed.
• A provision should be used only for the purpose for which it was originally recognized or set up.
Future Operating Losses

NOT Permissible to recognize a provision for future operating losses –

➔ Because they do not meet the criteria for recognition of a provision –

➔ As future losses are not present obligations arising from past obligating events and could be avoided by a future action of the entity.
Onerous Contracts

• Although Executory contracts are outside the general purview of Ind-AS 37, it is required to recognize a provision under an Executory contract that is “onerous.” An onerous contract that is covered under Ind-AS 37 is an Executory contract where the unavoidable costs exceed the benefits expected.
Onerous Contracts

• An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
Example.

An entity is bound under the terms of a franchise agreement for a local brand that it has marketed for years. Based on market survey and a cost-benefit study, the entity decided to stop marketing the local brand and entered into a new agreement to market an international brand. Although the entity does not derive any economic benefit from the franchise agreement for the local brand, there is an obligation to pay a lump-sum amount to the franchiser under the non cancelable franchise agreement for a period of two more years. **Thus the entity would need to make a provision for the commitment under the franchise agreement (since it is an onerous contract).**
Case Study 3

• **Facts**

XYZ Inc. is getting ready to move its factory from its existing location to a new industrial free zone specially created by the government for manufacturers. To avail itself of the preferential licensing offered by the local governmental authorities as a reward for moving into the free trade zone and the savings in costs that would ensue (since there are no duties or taxes in the free trade zone), XYZ Inc. has to move into the new location before the end of the year. The lease on its present location is non-cancelable and is for another two years from year-end. The obligation under the lease is the annual rent of $100,000.
Solution

• The lease agreement is an onerous contract because after moving to the new location, XYZ Inc. would derive no economic benefits from the existing factory building but would still need to pay rent under the agreement since the lease is non-cancelable. Thus the unavoidable costs exceed the benefits expected under the lease contract. Based on the annual lease obligation under the lease agreement, the total amount needed to be provided at year-end is the present value of the total commitment under the lease = PV of [$100,000 × 2 (years)].
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 entity; or

(b) the manner in which that business is conducted.
Restructuring – Examples

• Sale or termination of a line of business

• Closure of business locations in a region or relocation of business activities from one location to another

• Changes in management structure, such as elimination of a layer of management

• Fundamental reorganization of the entity such that it has a material and a significant impact on its operations.
• When to Recognise Restructuring Provisions?

• A constructive obligation arises when, and only when, an entity

  • Has a detailed formal plan for the restructuring outlining at least the business or part of the business being restructured;

• Has raised valid expectations in the minds of those affected that the entity will carry out restructuring by starting to implement that plan or announcing its main features to those affected by it.
• Which Costs should be included?

• Should include only direct expenditures arising from the restructuring, which are those that are necessarily entailed by the restructuring and NOT associated with the ongoing activities of the entity.
• What should not Constitute Cost of Restructuring?

• Costs of retraining or relocating continuing staff
• Marketing
• Investment in new systems and distribution networks
Case Study

• The board of directors of ABC Inc. at their meeting held on December 15, 20X1, decided to close down the entity’s international branches and shift its international operations and consolidate them with its domestic operations. A detailed formal plan for winding up the international operations was also formalized and agreed by the board of directors in that meeting. Letters were sent out to customers, suppliers, and workers soon thereafter. Meetings were called to discuss the features of the formal plan to wind up international operations, and representatives of all interested parties were presenting those meetings.

Do the actions of the board of directors create a constructive obligation that needs a provision for restructuring?
**Solution**

- There should be detailed formal plan of restructuring;

- Which should have raised valid expectations in the minds of those affected that the entity would carry out the restructuring by announcing the main features of its plans to restructure.

The board of directors did discuss and formalize a formal plan of winding up the international operations. This plan was communicated to the parties affected and created a valid expectation in their minds that ABC Inc. will go ahead with its plans to wind up international operations. Thus there is a constructive obligation that needs to be provided at year-end.
Disclosures

- For each class of provision, an entity should disclose:
  - The carrying amount at the beginning and the end of the period
  - Additional provisions made in the period, including increases to existing provisions
  - Amounts utilized during the period
  - Unused amounts reversed during the period
  - The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate
• An entity should also disclose, for each class of provision
  • A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits
  • An indication about the uncertainties about the amount and timing of those outflows (and, where necessary, major assumptions made concerning future events)
  • The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement

• In extremely rare circumstances, when disclosure of any or all this information is considered to be seriously prejudicial to the position of the entity in a dispute with other parties on the subject matter of the provision, an entity 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.
CONTINGENT LIABILITIES

Possible Obligation

• In order to recognize a provision (and record it on the books as opposed to only disclosing it in footnotes), certain conditions (as discussed earlier) need to be satisfied. However, when one of the prescribed conditions is not satisfied, then a provision cannot be recognized. It is then a contingent liability and needs to be disclosed in footnotes, unless the probability of the outflow embodying economic benefits is remote (in which case it does not even have to be disclosed).

• A contingent liability is a possible obligation arising from past events, the outcome of which will be confirmed only on the occurrence or nonoccurrence of one or more uncertain future events. A contingent liability is also a present obligation that is not recognized, either because it is not probable that an outflow of resources will be required to settle an obligation or the amount of the obligation cannot be measured with sufficient reliability.
• Once recognized as a contingent liability, an entity should continually assess the probability of the outflow of the future economic benefits relating to that contingent liability. If the probability of the outflow of the future economic benefits changes to more likely than not, then the contingent liability may develop into an actual liability and would need to be recognized as a provision.
Disclosures

• Unless the possibility of any outflow is remote, for each class of contingent liability an entity should disclose at the balance sheet date a brief description of the nature of the contingent liability and, where practicable
  • An estimate of its financial effect;
  • An indication of the uncertainties relating to the amount or timing of any outflow; and
  • The possibility of any reimbursement.
Where any of the information required above is not disclosed because it is not practicable to do so, the fact should be disclosed.

• In extremely rare circumstances, when disclosure of any or all the above information is considered to be seriously prejudicial to the position of the entity in a dispute with other parties on the subject matter of the contingent liability, an entity 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.
Case Study

• **Facts**
  Amazon Inc. has been sued for following three alleged infringements of law:
  (1) Unauthorized use of a trademark; the claim is for $100 million
  (2) Nonpayment of end-of-service severance pay and gratuity to 5,000 employees who were terminated without Amazon Inc. giving any reason; the class action lawsuit is claiming $3 million
  (3) Unlawful environmental damage for dumping waste in the river near its factory; environmentalists are claiming unspecified damages as cleanup costs
  Legal counsel is of the opinion that not all the legal cases are tenable in law and has communicated to Amazon Inc. this assessment of the three lawsuits:
  **Lawsuit 1:** The chances of this lawsuit are remote.
Lawsuit 2: It is probable that Amazon Inc. would have to pay the displaced employees, but the best estimate of the amount that would be payable if the plaintiff succeeds against the entity is $2 million.

Lawsuit 3: There is no current law that would compel the entity to pay for such damages. There may be a case for constructive obligation, but the amount of damages cannot be estimated with any reliability.
• **Lawsuit 1:** Because the probability of an outflow of economic benefits is remote, no provision or disclosure is required.

• **Lawsuit 2:** Because it is probable ("more likely than not") that Amazon Inc. would ultimately have to pay the dues to the displaced employees and the best estimate of the settlement is $2 million (as against the claim of $3 million), Amazon Inc. would have to make a provision for $2 million.

• **Lawsuit 3:** There is no legal obligation, but there is a constructive obligation. However, an estimate of the obligation with reasonable reliability is not possible. Hence this qualifies for disclosure as a contingent liability because it cannot be recognized as a provision (as it does not meet all the prescribed conditions for recognition of a provision).
CONTINGENT ASSETS
(Possible Assets)

- Contingent assets are possible assets that arise from a past event and whose existence is confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the entity.
DISCLOSURES

• Where inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the balance sheet date and, where practicable, an estimate of their financial estimate.

• Where any of the information required above is not disclosed because it is not practicable to do so, the fact should be disclosed.

• In extremely rare circumstances, when disclosure of any or all the above information is considered to be seriously prejudicial to the position of the entity in a dispute with other parties on the subject matter of the contingent asset, an entity 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.
Case Study 6

• **Facts**
  A Singapore-based shipping company lost an entire shipload of cargo valued at $5 million on a voyage to Australia. It is, however, covered by an insurance policy. According to the report of the surveyor the amount is collectible, subject to the deductible clause (i.e., 10% of the claim) in the insurance policy. Before year-end, the shipping company received a letter from the insurance company that a check was in the mail for 90% of the claim. The international freight forwarding company that entrusted the shipping company with the delivery of the cargo overseas has filed a lawsuit for $5 million, claiming the value of the cargo that was lost on high seas, and also consequential damages of $2 million resulting from the delay. According to the legal counsel of the shipping company, it is probable that the shipping company would have to pay the $5 million, but it is a remote possibility that it would have to pay the additional $2 million claimed by the international freight forwarding company, since this loss was specifically excluded in the freight forwarding contract.

• **Required**
  What provision or disclosure would the shipping company need to make at year-end?
• The shipping company would need to recognize a contingent asset of $4.5 million (the amount that is virtually certain of collection). Also it would need to make a provision for $5 million toward the claim of the international freight forwarding company. Because the probability of the claim of $2 million is remote, no provision or disclosure would be needed for that.
MULTIPLE-CHOICE QUESTIONS

1. When can a “provision” be recognized in accordance with Ind-AS 37?
   (a) When there is a legal obligation arising from a past (obligating) event, the probability of the outflow of resources is more than remote (but less than probable), and a reliable estimate can be made of the amount of the obligation.
   (b) When there is a constructive obligation as a result of a past (obligating) event, the outflow of resources is probable, and a reliable estimate can be made of the amount of the obligation.
   (c) When there is a possible obligation arising from a past event, the outflow of resources is probable, and an approximate amount can be set aside toward the obligation.
   (d) When management decides that it is essential that a provision be made for unforeseen circumstances and keeping in mind this year the profits were enough but next year there may be losses.
MULTIPLE-CHOICE QUESTIONS

• 2. Amazon Inc. has been served a legal notice on December 15, 20X1, by the local environmental protection agency (EPA) to fit smoke detectors in its factory on or before June 30, 20X2 (before June 30 of the following year). The cost of fitting smoke detectors in its factory is estimated at $250,000. How should Amazon Inc. treat this in its financial statements for the year ended December 31, 20X1?

(a) Recognize a provision for $250,000 in the financial statements for the year ended December 31, 20X1.

(b) Recognize a provision for $125,000 in the financial statements for the year ended December 31, 20X1, because the other 50% of the estimated amount will be recognized next year in the financial statement for the year ended December 31, 20X2.

(c) Because Amazon Inc. can avoid the future expenditure by changing the method of operations and thus there is no present obligation for the future expenditure, no provision is required at December 31, 20X1, but as there is a possible obligation, this warrants disclosure in footnotes to the financial statements for the year ended December 31, 20X1.

(d) Ignore this for the purposes of the financial statements for the year ended December 31, 20X1, and neither disclose nor provide the estimated amount of $250,000.

• Answer: (c)
MULTIPLE-CHOICE QUESTIONS

3. A competitor has sued an entity for unauthorized use of its patented technology. The amount that the entity may be required to pay to the competitor if the competitor succeeds in the lawsuit is determinable with reliability, and according to the legal counsel it is less than probable (but more than remote) that an outflow of the resources would be needed to meet the obligation. The entity that was sued should at yearend:
   (a) Recognize a provision for this possible obligation.
   (b) Make a disclosure of the possible obligation in footnotes to the financial statements.
   (c) Make no provision or disclosure and wait until the lawsuit is finally decided and then expense the amount paid on settlement, if any.
   (d) Set aside, as an appropriation, a contingency reserve, an amount based on the best estimate of the possible liability.

Answer: (b)
MULTIPLE-CHOICE QUESTIONS

4. A factory owned by XYZ Inc. was destroyed by fire. XYZ Inc. lodged an insurance claim for the value of the factory building, plant, and an amount equal to one year’s net profit. During the year there were a number of meetings with the representatives of the insurance company. Finally, before year-end, it was decided that XYZ Inc. would receive compensation for 90% of its claim. XYZ Inc. received a letter that the settlement check for that amount had been mailed, but it was not received before year-end. How should XYZ Inc. treat this in its financial statements?

(a) Disclose the contingent asset in the footnotes.
(b) Wait until next year when the settlement check is actually received and not recognize or disclose this receivable at all since at year-end it is a contingent asset.
(c) Because the settlement of the claim was conveyed by a letter from the insurance company that also stated that the settlement check was in the mail for 90% of the claim, record 90% of the claim as a receivable as it is virtually certain that the contingent asset will be received.
(d) Because the settlement of the claim was conveyed by a letter from the insurance company that also stated that the settlement check was in the mail for 90% of the claim, record 100% of the claim as a receivable at year-end as it is virtually certain that the contingent asset will be received, and adjust the 10% next year when the settlement check is actually received.

• Answer: (c)
Thank You