

IAS 37

Provisions, Contingent Liabilities and Contingent Assets

Provision

Liability of uncertain timing or amount

Present obligation from past events

Outflow of
economic
benefits

Legal Obligation

Constructive
Obligation

When to recognize a provision

There must be a **present obligation** as a result of a **past event**;

The **outflow of economic benefits** to satisfy the obligation must be **probable** (i.e. more than 50% probable)

The amount of economic benefits required to satisfy the obligation must be **reliably estimated**

When to recognize a provision – Decision Tree

**Can the obligation be avoided by some
future actions**

Yes

No

**Do not recognise
the provision**

**Recognise the
provision**

How to measure a provision

The amount of the provision should be measured at the **best estimate of the expenditures** required to satisfy the obligation at the end of the reporting period;



Management should really **incorporate all available information in their estimates** and they must not forget about:

[**Note:** Gains from the expected disposal of assets shall not be taken into account in measuring a provision – Para 51]

Risks and uncertainties (like inflation),

Time value of money (discounting when the settlement is expected in the long-term future)

Some probable future events, etc.

Trade payables and accruals

- **Provisions can be distinguished from other liabilities** such as trade payables and accruals;
- **Trade payables** are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier;
- **Accruals** are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay)
- **Note:** Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately

Reimbursements

- Sometimes, **entities have right to reimbursement of related expenditures by the third** party (e.g. from an insurance company);
- In this case, a right to reimbursement is recognized as a separate asset (**no netting off with the provision itself**)

Future operating losses	Onerous contracts	Restructuring
<p>Should not make a provision for future operating loss Because there is no past event and the future operating losses can be avoided by some future actions</p>	<p>Onerous contract is a contract in which unavoidable costs of fulfilling exceed the benefits from the contract</p>	<p>Restructuring is a plan of management to change the scope of business or a manner of conducting a business</p>
<p>Test your assets for impairment under IAS 36 Impairment of Assets</p>	<p>Loss contract that cannot be avoided. Hence, make a provision in the amount lower of:</p> <ol style="list-style-type: none"> 1) Unavoidable costs of fulfilling the contract or 2) Penalty for not meeting your obligations from the contract 	<p>In the case of restructuring, an obligation to restructure arises only if:</p> <ol style="list-style-type: none"> 1) There is a detailed formal plan for restructuring; and 2) A valid expectation related to restructuring has been raised in the affected parties

Contingent liabilities

A contingent liability is either:

A possible obligation (not present) from past event that will be confirmed by some future event; or

A present obligation arising from the past event, but either:

The outflow of economic benefits to satisfy this obligation is **not probable** (i.e. less than 50%), or

The amount of obligation **cannot be reliably measured** (this is very rare, in fact)

Contingent assets

- A **contingent asset** is a possible asset arising from past events that will be confirmed by some future events not fully under the entity's control.



Ind AS 16

**Property,
Plant and
Equipment**

Property, plant and equipment are tangible items that:

are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

are expected to be used during more than one period.

The cost of an item of property, plant and equipment shall be **recognised as an asset** if, and only if:

it is probable that future economic benefits associated with the item will flow to the entity; and

the cost of the item can be measured reliably.

Measurement

Property, plant and equipment will be measured at cost.
The cost comprises:



purchase price, including import duties and non-refundable taxes, after deducting trade discounts and rebates;



any costs directly attributable to bringing the asset to the location, and condition; and



the initial estimate of the costs of dismantling, and removing the item, and restoring the site on which it is located

On 1.4.2016, X Limited acquired a machine for Rs. 50 lakhs. The down payment is 20% and balance shall be paid over 5 equal annual instalments. Incremental borrowing rate is 11%. Find out the cost of machine.

Acquisition cost = PV of cash flows @ 11% = Rs. 39.57

Year	Cash Flows	PVF	PV	Finance Cost	Creditors
0	10	1	10.00	0	29.57
1	8	0.9009	7.21	3.25	24.82
2	8	0.8116	6.49	2.73	19.55
3	8	0.7312	5.85	2.15	13.70
4	8	0.6587	5.27	1.51	7.21
5	8	0.5935	4.75	0.79	0.00
	50.00		39.57	10.43	

The finance cost shall be recognised over the period of deferred credit

Date	Particulars	Dr.	Cr.
1.4.2016	PPE – Machine A/c Dr.	39.57	
	To S. Crs. A/c		29.57
	To Bank A/c		10.00
31.3.2017	Finance Costs A/c Dr.	3.25	
	To S. Crs. A/c		3.25
31.3.2017	S. Crs. A/c Dr.	8.00	
	To Bank A/c		8.00

Case Study

- An entity has acquired a building for Rs. 15,00,000, with a useful life of 5 years;
- The cost of demolishing the building (i.e. asset retirement obligation or ARO) at the end of its use as required by local regulations has the nominal value of INR 500,000;
- Discount rate applicable for the entity is 10%.
- **Sol.:** Recognise ARO of INR 310,461 (PV of Rs. 5,00,000 @10%)

Year	Op. Prov.	Intt. Exp.	Cl. Prov.	Dep.
1	310,461	31,046	341,507	62,092
2	341,507	34,151	375,657	62,092
3	375,657	37,565	413,223	62,092
4	413,223	41,322	454,545	62,092
5	454,545	45,454	500,000	62,092

Particulars	Dr.	Cr.
PPE A/c Dr.	18,10,461	
To Sundry Creditors A/c		15,00,000
To Prov. For Decommission Liab. A/c		3,10,461
Interest – Finance Cost A/c Dr.	31,046	
To Prov. For Decommission Liab. A/c		31,046
Dep. A/c Dr. [3,00,000 + 62,092]	3,62,092	
To PPE A/c		3,62,092

Directly attributable costs

IAS 16 says that we can capitalize any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management

Can be capitalized

1. Costs of employee benefits
2. Costs of site preparation
3. Initial delivery and handling costs
4. Installation and assembly costs
5. Costs of testing whether the asset is functioning properly
6. Professional fees

Cannot be capitalized

1. Costs of opening a new facility
2. Costs of introducing a new product or service
3. Costs of conducting a business in a new location or with a new class of customer
4. Administration and other general overhead costs

Ind AS 116: Leases

By:

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Introduction

- **Ind AS 116 is effective from 1.4.2019** and onwards which introduced few **major changes** such as:
 - ❑ **New definition of the lease:** it can cause that some contracts previously treated as “service contracts” can now be treated as “lease contracts”
 - ❑ **Accounting for leases in the lessee’s F.S.:** it has changed and lessees do not classify the lease into finance lease or operating lease, anymore. Instead, they should account for all the leases in ‘single accounting model – i.e. ROU model’.
- **Objective:** Under the new standard, **lessees will need to show all the leases right in their statement of financial position** instead of hiding them in the notes to the financial statements – Earlier, when the lease was classified as operating, then the lessees did not show either asset or liability in their B.S. – just the lease payments as an expense in P & L - But, some operating leases were non-cancellable, and therefore, they represented a liability (and an asset) for the lessees.

What is a lease

116

A contract is or contains a lease if:

- it conveys the **right to control**
- the use of an **identified asset**
- for a **period of time**
- in exchange for **consideration**

If the answer to these questions is YES, then it's probable that your contract contains a lease

to be asked:

- Can the asset be identified - e.g. is it physically distinct?
- Can the customer direct and decide about the asset's use?
- Can the customer get substantially all the economic benefits from the use of that asset?
- Can't the supplier substitute the asset during the period of use?

Impact

- The **definition of lease is much broader** than under the old Ind AS 17.
- The impact of this new broader definition can be quite big, because some service contracts (with payments recognized directly in P & L) can now be considered as lease contracts (with **necessity to recognize right-of-use asset and lease liability**).
- Under Ind AS 116, you need to **separate lease and non-lease components** in the contract **on the basis of relative stand alone prices**.
- **For example**, if you rent a warehouse and rental payments include the fees for cleaning services, then you should separate these payments between the lease payments and service payments and account for these elements separately.
- However, **lessee can optionally choose not to separate these elements**, but account for the whole contract as a lease (this applies for the whole class of assets).



**Accounting
for leases
by lessees**

Warning: Lessees do NOT classify the leases as finance or operating anymore!

Initial recognition: At lease commencement, a lessee accounts for two elements:

Subsequent measurement: After commencement date, lessee needs to take care about both elements recognized initially:

Right-to-use asset i.e. amount of the lease liability and initial direct costs

Lease liability i.e. PV of all payments not paid at the commencement date

Right-of-use asset: account for as per IAS 16/ IAS 40

Lease liability: account for as per IAS 37

Journal Entries

Initial Recognition

Subsequent Measurement

Lessee takes an asset under the lease:

Right-of-use asset Dr.
To Lease liability

Depreciate the asset over the lease term:

P & L – Depreciation charge Dr.
To Acc. Dep. of right-of-use asset

Lessee pays the legal fees for negotiating the contract:

Right-of-use asset Dr.
To Suppliers/ Bank

Recognize an interest on the lease liability:

P & L – Interest expense Dr.
To Lease liability

The estimated cost of removal, discounted to PV - cost for removing an asset and restore the site at the end of lease term):

Right-of-use asset Dr.
To Prov. for asset removal (IAS 37)

Lease payments are recognized as a reduction of the lease liability:

Lease liability Dr.
To Bank account (cash)

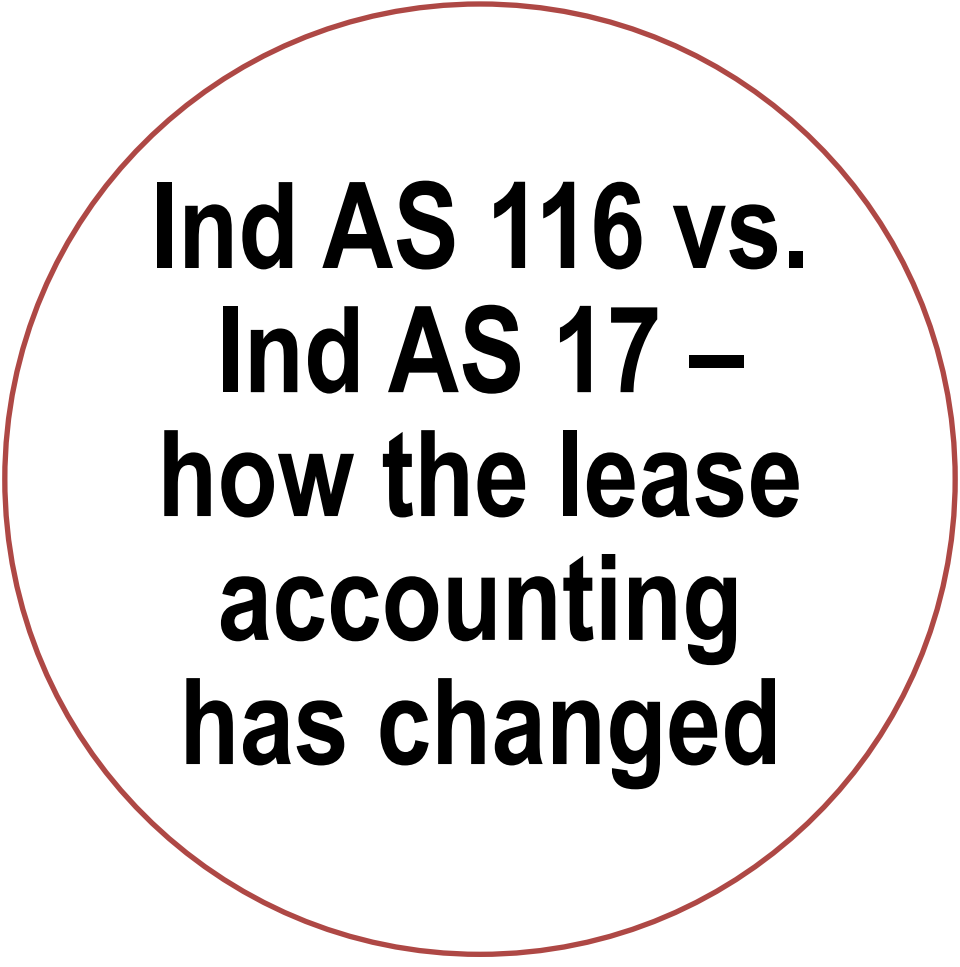
Optional Exemptions

Lease term < 12 months with no purchase option

Underlying asset has low value

You can simply account for all payments made **directly in profit or loss on a straight-line (or other systematic) basis.**

So, if you enter into the contract for the lease of PC, or you rent a car for 4 months, then you don't need to bother with accounting for the right-of-use asset and the lease liability



**Ind AS 116 vs.
Ind AS 17 –
how the lease
accounting
has changed**

Example 1: Identified Asset

- Imagine you want to rent some space in the warehouse for storing your goods. You'd like to enter into a **3-year rental contract**. The owner of that warehouse offers 2 options to you:
- **Option 1:** You will occupy a certain area of XY square feet, but the specific place will be determined by the owner of the warehouse, based on actual usage of the warehouse and free storage.
- **Option 2:** You will occupy the 'Block No. 13' of XY square feet in the Sector 'A' of that warehouse. This place is assigned to you and no one can change it during the duration of the contract.

- Both contracts look like lease contracts, and indeed, in both cases, you would book the rental payments an expense in profit or loss under older Ind AS 17.
- Under new Ind AS 116, you need to assess **whether these contracts contain lease as defined in Ind AS 116.**
- The first contract **does not contain any lease, because no asset can be identified.** The reason is that the supplier (warehouse owner) can exchange one place for another and you lease only certain capacity. Therefore, you would account for rental payments as for expenses in P & L.
- The second contract **does contain a lease, because an underlying asset can be identified** – you are leasing the Block No. 13 of XY square feet in the Sector 'A'. Therefore, you need to account for this contract as for the lease and it means recognizing some asset and a liability in your balance sheet.

Example 2: Do we pay only for a lease, or also for some services

- When you lease some assets under operating lease (as called by older Ind AS 17), in most cases, a lessor provides certain services to you, such as maintenance, repairs, cleaning, etc.
- Under older Ind AS 17, you did not need to think about it too much, because you put all lease payments as some rental expense to your profit or loss.
- Under new Ind AS 116, you need to **split the rental or lease payments into lease element and non-lease element**, because you need to:
 - account for a lease element as for a lease under Ind AS 116; and
 - account for a service element as before, in most cases as an expense in profit or loss.

- Let's say you took the option 2 and you pay Rs. 10,000 per year. This payment includes the payment for rental of the Block No. 13 and its cleaning once per week.
- Therefore, you need **to split the payment of Rs. 10,000 into lease element and cleaning element** based on their **relative stand-alone selling prices** (i.e. for similar contracts when got separately).
- You find out that you would be able to rent out similar unit in the warehouse next door for Rs. 9,000 per year without cleaning service, and you would need to pay Rs. 1,500 per year for its cleaning.
- Based on this, you need to:
 - Allocate Rs. 8,571 [$\text{Rs. } 10,000 \times (\text{Rs. } 9,000 / (\text{Rs. } 9,000 + \text{Rs. } 1,500))$] to the lease element and account for that as for the lease; and
 - Allocate Rs. 1,429 [$\text{Rs. } 10,000 \times (\text{Rs. } 1,500 / (\text{Rs. } 9,000 + \text{Rs. } 1,500))$] to the service element and in this case, probably recognize it in profit or loss as an expense for cleaning.

- **Assumption:** Discount rate is 5% and Lease term is 3 years
- Under Ind AS 17, based on the warehouse's economic life, lease payments, etc. say you assessed that this lease is operating, then the accounting is very simple – at the commencement, you did nothing and then at the end of each year, you simply book the rental expense of Rs. 10,000 in profit or loss.
- Under Ind AS 116:
 - **no classification is necessary** as one accounting model applies to all leases
 - separate the non-lease element (cleaning element) from the lease element
 - do initial recognition
 - do subsequent measurements
- **Present value of lease payments over the lease term = Rs. 23,341** i.e. present value of 3 payments of Rs. 8,571 (only lease element) at 5%

Year	Lease liability b/f	Add interest at 5%	Less amounts paid	Lease liability c/f
1	23,341	1,167	-8,571	15,937
2	15,937	797	-8571	8,163
3	8,163	408	-8571	0
		2,372	-25,713	

When	What	How much	Debit	Credit
<i>At the beginning</i>	Right-of-use asset (+) lease liability	23,341	Right-of-use asset	Lease liability
<i>At the end of the year 1</i>	Interest	1,167	P/L: Interest expense	Lease liability
	Rental payment	8,571	Lease liability	
		1,429	P/L: Expenses for cleaning services	
		10,000		Bank A/c
	Depreciation (23,341/ 3)	7,780	P/L: Depreciation	Right-of-use asset

Comparative Analysis for overall 3 years

Type of expense	Ind AS 17	Ind AS 116	Note
Rental expense	30,000	-	10,000 (x) 3
Interest expense	-	2,372	Table above
Depreciation	-	23,341	7,780 (x) 3
Cleaning expenses	-	4,287	1,429 (x) 3
Total	30,000	30,000	

In total, both models have the same profit or loss impact over total lease term.


Comparative Analysis for only 1 year

Type of expense	Ind AS 17	Ind AS 116	Note
Rental expense	10,000	-	10,000 (x) 1
Interest expense	-	1,167	Table above
Depreciation	-	7,780	7,780 (x) 1
Cleaning expenses	-	1,429	1,429 (x) 1
Total	10,000	10,376	

Ind AS 117



Introduction



Replaces Ind AS 104: Ind AS 117, *Insurance Contracts*, is a comprehensive standard that sets out principles for the **financial reporting of insurance contracts**, replacing the interim standard Ind AS 104;

Scope: The standard applies to insurance contracts issued, reinsurance contracts held, and investment contracts with discretionary participation features;

Effective date: The Ministry of Corporate Affairs (MCA) notified Ind AS 117 on August 12, 2024. This new accounting standard will be **applicable from April 1, 2024**;

Recognition and Measurement

General Measurement Model (GMM): This is the default model, where the liability is measured as the present value of future cash flows, adjusted for risk and a contractual service margin (CSM), which defers profit recognition over time.

Premium Allocation Approach (PAA): A simplified model applicable to short-term contracts, where the liability is based on unearned premiums and claims.

Variable Fee Approach (VFA): Used for participating contracts where policyholders share in the returns on underlying assets.

Insurance Contract

- A contract under which one party (the issuer) accepts **significant insurance risk** from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder

Insurance Contract

- A contract under which one party (the issuer) accepts **significant insurance risk** from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder;

Features

- **Transfer of Insurance Risk:** The contract transfers significant insurance risk from the policyholder to the insurer. This risk must relate to an uncertain future event that could adversely affect the policyholder.
- **Compensation upon Occurrence of Insured Event:** The insurer agrees to compensate the policyholder if a specified uncertain future event (the insured event) occurs.
- **Uncertainty:** The insured event must be uncertain in nature, either in terms of its timing, occurrence, or magnitude. The insurer must bear the risk of a potential loss.
- **Significant Insurance Risk:** The risk transferred must be significant. This means that the potential loss to the insurer must be substantial relative to the benefits provided by the policyholder.



Assessing Insurance Contracts

Insurance vs. Non-Insurance Warranties

Key Factors	Insurance Contract (Ind AS 117)	Non-Insurance Contract (Ind AS 115 or Ind AS 37)
Risk Transfer	Involves significant insurance risk for future uncertainties	No significant risk transfer; quality guarantees or services
Nature of Coverage	Covers uncertain future events like breakdowns, accidents	Covers product defects or ensures product performance
Premium/ Payment	Separate payment/ premium charged for the warranty	Bundled into product price; no distinct premium
Purpose of the Contract	Indemnifies for loss; compensates for future uncertain events	Provides maintenance or quality assurance services

Guarantees and LD ~ Analysis

Performance Guarantee	Financial Guarantee	Liquidated Damages
Qualifies as an insurance contract if compensation covers unexpected external factors, not operational risks	Qualifies as an insurance contract if the default is due to unforeseen economic events, not credit risk	Qualifies as an insurance contract if the delay is caused by unforeseen events (e.g., natural disasters), not regular project issues