**Illustration A**

## Tables - Provisions, Contingent Liabilities and Reimbursements

*The purpose of this illustration 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

| **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.** | | |
|---|---|---|
| **There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.** | **There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.** | **There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.** |
| A provision is recognised (paragraph 14). Disclosures are required for the provision (paragraphs 66 and 67) | No provision is recognised (paragraph 26). Disclosures are required for the contingent liability (paragraph 68). | No provision is reco gnised (paragraph 26). No disclosure is required (paragraph 68). |

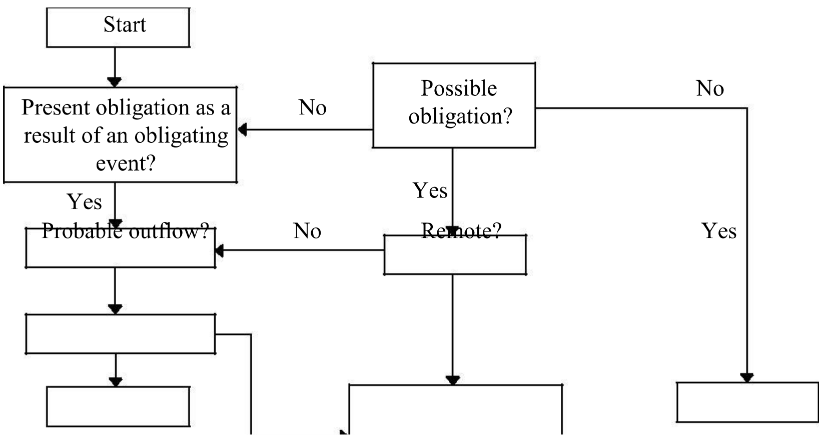
### Reimbursements

| **Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.** | | |
|---|---|---|
| **The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.** | **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.** | **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.** |
| The enterprise has no liability for the amount to be reimbursed (paragraph 50). | 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 46 and 47). | The expected reimbursement is not recognised as an asset (paragraph 46). |
| No disclosure is required. | The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 67(c)). | The expected reimbursement is disclosed (paragraph 67(c)). |

## Illustration 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.*



Yes

Reliable estimate?

Yes No (rare)

Provide

Disclose contingent liability

Do nothing

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).

**Illustration C**

**Illustration: Recognition**

*This illustration 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 Illustrations have 31 March year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some Illustrations 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 Illustrations indicate paragraphs of the Accounting Standard that are particularly relevant. The illustration should be read in the context of the full text of the Accounting Standard.*

**Illustration 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).

**Illustration 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 March 2005 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).

**Illustration 3: Offshore Oil field**

An enterprise operates an offshore oil field 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.

**Illustration 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).

**Illustration 5: Legal Requirement to Fit Smoke Filters**

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2005. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 March 2005

**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 March 2006

**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).

**Illustration 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 work force 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).

**Illustration 7: A Single Guarantee**

During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 200506, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

(a) At 31 March 2005

**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 March 2005.

**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 68).

(b) At 31 March 2006

**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 March 2006, 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.

**Illustration 8: A Court Case**

After a wedding in 2004-05, 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 March 2005, 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 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2005

**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 68).

(b) At 31 March 2006

**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).

**Illustration 9A: 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.

**Illustration 9B: Refurbishment Costs -Legislative Requirement**

An airline is required by law to overhaul its aircraft once every 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 costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in illustration 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

**Illustration 10: An onerous contract**

An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2005 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

**Present obligation as a result of a past obligating event -**The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits in settlement -** When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the enterprise accounts for the lease under AS 19, Leases).

**Conclusion -**A provision is recognised for the best estimate of the unavoidable lease payments.

**Illustration D**

**Illustration: Disclosures**

*This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning. An illustration of the disclosures required by paragraph 67 is provided below.*

**Illustration 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 illustration is given below of the disclosures required by paragraph 72 where some of the information required is not given because it can be expected to prejudice seriously the position of the enterprise.*

**Illustration 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 66 and 67 of the Standard. 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 29, 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.*