DEWAN P.N. CHOPRA & CO.

AUDIT UPDATE

THE IMPACT OF COVID-19 – PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Due to COVID-19, there is a need for exercising judgement in making provisions for losses and claims. A provision may be accounted for only to the extent that there is a present obligation for which the outflow of economic benefits is probable and can be reliably estimated.

Ind AS 37/AS-29 does not permit provisions for future operating costs or future business recovery costs. However, it requires that an entity should disclose the nature of the obligation and the expected timing of the outflow of economic benefits.

Ind AS 37 requires a provision to be recognised only

- where an entity has a present obligation
- it is probable that an outflow of resources is required to settle the obligation; and
- a reliable estimate can be made.

Entities to whom Ind AS is applicable

Provisions, Contingent Liabilities and Contingent Assets

1. **Onerous contracts**

Indian Accounting Standards provide specific guidance for **onerous (loss making) contracts** – i.e. those in which the unavoidable costs of meeting the obligations exceed the economic benefits expected to be received under the contract. The unavoidable costs are the lower of the net costs of fulfilling the contract and the cost of terminating it.

A sales contract may become onerous if costs rise or are expected to rise – e.g. because the company needs to stop production, find an alternative supplier or hire additional employees. A sales contract may also become onerous if benefits are expected to be lower – e.g. because a fall in demand affects the pricing. When assessing the unavoidable costs, companies should consider the contract terms carefully, including termination and force majeure clauses.

When preparing projections of costs and benefits for the onerous contract test, a company needs to reflect expectations at the reporting date and use assumptions that are consistent with those used for other recoverability assessments – e.g. impairment of non-financial assets. As the situation surrounding Covid-19 is rapidly changing, a company may need to update projections it made before the reporting date to reflect the information available, conditions and outlook at the reporting date.

The provision for an onerous contract is discounted if the effect of the time value of money is material. Central banks in many countries are cutting interest rates in response to increasing concerns about the economic impact of Covid-19; this in turn may impact risk-free rates, which are often used to discount provisions. Companies need to update the discount rate if it has changed.

Before recognizing a provision for an onerous contract, a company tests all assets dedicated to the contract for impairment.

Additionally, there could be losses from imposition of penalty due to delay in supply of goods, which may need to be considered under the guidance of Ind AS 115, Revenue from Contracts with Customers.

If the management is unable to assess whether some of the executory contracts are onerous due to inadequacy of information, the same should be disclosed. Management should disclose that it has assessed whether executory contracts are onerous due to the adverse impact of COVID -19. If, the management is unable to assess whether some of the executory contracts have become onerous due to inadequacy of information, the same should be disclosed.

2. Penalties

Under Indian Accounting Standards, if a company has a present obligation, which cannot be avoided and is expected to result in the outflow of economic resources, then it recognises a provision if the amount can be estimated reliably.

Companies need to review their existing contracts and consider the interpretation of applicable law, particularly **force majeure clauses**, to determine whether they have an obligation triggered by Covid-19. In some cases, this may require them to recognise additional provisions – e.g. for failure to comply with applicable laws and regulations. Conversely, in some countries the outbreak may be regarded as force majeure and penalties for non-performance, late delivery or cancellation may be waived. This assessment may require legal advisors to be involved.

3. Restructuring costs

The Standard provides that a provision for restructuring costs is recognised only when the general recognition criteria for provisions are met and when there is a detailed formal plan for the restructuring and there is evidence that the entity has started to implement a restructuring plan, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan.

4. Contingent Assets - Insurance claims

Entities may have insurance policies that cover loss of profits due to business disruptions due to events like COVID-19. Entities claims on insurance companies can be recognised in accordance with **Ind AS 37** only if the recovery is virtually certain i.e. the insurance entities have accepted the claims and the insurance entity will meet its obligations.

Entities to whom AS is applicable

AS 29 Provisions, Contingent Liabilities and Contingent Assets

Onerous contracts are those contracts for which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Unavoidable costs under a contract are the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. As a result of COVID -19, some contracts may become onerous for reasons such as the imposition of penalty due to delay in supply of goods or increase in cost of material, labour, etc. Management should consider whether any of its contracts have become onerous. The same should be accounted for as per AS 29. Management should disclose that it has assessed whether executory contracts are onerous due to adverse impact of COVID -19. If, the management is unable to assess whether some of the executory contracts have become onerous due to the inadequacy of information, the same should be disclosed.

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