Creation of provision for contingencies

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

A. Facts of the Case

1. A company was incorporated in March 1977 under section 25 of the Companies Act, 1956. The main objective of the company is to promote India's trade. One of the medium of promoting the trade is organising trade fairs and exhibitions in various parts of the country, as well as in other countries. The fairs/exhibitions organised by the company as also by outside agencies attract large crowds.

2. The querist has stated that from the year 2000-01, it was decided to charge 5% contingency charges from the participants/ outside agencies on the income received from them by the company. While, in the case of fairs organised by outside agencies, 5% contingency charges are levied separately in the invoice, the contingency charges in respect of fairs organised by the company are inbuilt in the space rent charged from the participants. Both are credited to the income and expenditure account of the company. The intention of levying these charges is to meet any unforeseen liability which may arise in future. The instances of such unforeseen liabilities could be on account of injury/loss of life of visitors/exhibitors, etc., due to fire, terrorist attack, stampede, electrocution, natural calamities and other public/third party liability, statutory liabilities, etc. The chances of occurrence of these events are high due to visit of large crowds to the fairs/exhibitions. Besides, the likelihood of damage to participant's exhibits due to any of the reasons indicated above also exists.

3. According to the querist, as the recovery on account of contingency charges is being made to meet such unforeseen liability, as a prudent policy, a matching provision for the same is also being made by the company in the accounts to reflect a true and fair view of the state of affairs of the company. A suitable disclosure to this effect is also made in the notes forming part of accounts. The decision to levy the 5% contingency charges was based on an assessment only as the actual liability on this account cannot be estimated.

4. During the audit of accounts for the year 2002–03, the statutory auditors of the company felt that provision against unknown liabilities and the expenses of contingent nature, which are contingent/ unknown, is violative of the provisions of the Companies Act, 1956. In other words, the statutory auditors were of the view that no liability can be provided in the books of accounts unless the quantum of the liability and the details of the payee are known.

5. The querist had drawn the attention of the auditors to Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India (ICAI), wherein the word 'contingency' had been defined as a "condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events." In the opinion of the management, some events might occur in future which might affect the profitability of the company, and as a

safeguard, a provision to meet unforeseen liability could be made in the books of account. The company's contention that the matching provision was being made against the amounts being recovered to discharge any future liability, which might or might not occur, was however not accepted by the auditors and the accounts of the organisation were qualified by the statutory auditors on this aspect.

6. In order to sort out the issue, the querist had earlier referred the matter to the Expert Advisory Committee of the Institute of Chartered Accountants of India for the expert opinion as to whether creation of provision for contingencies as detailed above was in conformity with AS 4 issued by the ICAI. The Committee had opined that under the facts and circumstances of the case, the creation of the provision for contingencies was not in conformity with AS 4 and Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the ICAI and Schedule VI to the Companies Act, 1956. (A copy each of the query and the opinion of the Expert Advisory Committee has been separately provided by the querist for the perusal of the Committee.)

7. Accordingly, on the basis of the opinion received and after discussion with the statutory auditors, the provision for contingencies (balance sheet) standing in the books of account from 2000-01 to 2003-04 was reversed and credited as prior period income in the income and expenditure account for the accounts of the organisation for the year 2004-05. The Member Audit Board (MAB) [Comptroller and Auditor General of India (C&AG)], while reviewing the accounts, was, however, of the view that the provision for contingencies should be transferred to a special reserve account. This, according to the querist, was presumably on the basis of the wording of paragraph 13 of the opinion of the Expert Advisory Committee which, inter alia, states that "the Committee is of the view that since the contingencies stipulated by the company are not known at the balance sheet date, the provision in this regard cannot be created. Accordingly, the provision for contingencies created by the company is of the nature of a reserve." (A copy of the observation of the C&AG auditors and management reply has been separately provided by the querist for the perusal of the Committee).

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

   (i) Whether the accounting treatment given by the company is in conformity with the earlier opinion of the Expert Advisory Committee.

   (ii) Whether the view of the MAB office on the above issue that the provision for contingencies should be transferred to a special reserve account is correct.

   (iii) If the answer to (ii) above is in the affirmative, then what entry is required to be passed by the company for creating the special reserve in the books of account, i.e., whether the entry should be passed through the income and expenditure account or through general reserve account to the special reserve account.

C. Points considered by the Committee

9. The Committee notes from the Facts of the Case that the querist had earlier sought its opinion on the issue as to whether creation of provision for contingencies not known at the balance sheet date is appropriate, and that the Committee had opined that such a creation of provision for contingencies is not in conformity with AS

4, AS 29 and Schedule VI to the Companies Act, 1956. Accordingly, the Committee has not touched upon this issue again and has considered only the issue regarding accounting treatment of the provision erroneously created in the books of account in past.

10. With regard to the treatment of the provision for contingencies wrongly created in the books of account, the Committee notes the definition of the term 'prior period items' and paragraph 15 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India, which state as follows:

    ***"Prior period items** are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."*

    "15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."

11. On the basis of the above, the Committee is of the view that the provision for contingencies wrongly created in the financial statements of prior periods is a prior period item and hence, should be written back in the statement of profit and loss for the current period for determining the profit or loss for the period and should be shown separately. Thus, the question of transfer of such provision to 'reserve' account, as argued by the government auditors, does not arise. Regarding the expression used by the Committee, in its earlier opinion, based on the definitions of the terms, 'provision' and 'reserve' as per Schedule VI to the Companies Act, 1956 that such a provision is of the nature of reserve, the Committee is of the view that the aforesaid expression refers only to the nature of an item rather than recommending the accounting treatment. The company may, however, if it so desires, create a special reserve account in this regard by way of appropriation of profits.

D. Opinion

12. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 8 above:

    (i) Yes, the accounting treatment given by the company is in conformity with the earlier opinion of the Expert Advisory Committee.

    (ii) No, the view taken by MAB office on the issue that the provision for contingencies should be transferred to a special reserve account is not correct.

    (iii) Answer to this question does not arise as the answer to query (ii) above is not in the affirmative.

Notes:

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 Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty-four volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.