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PROVISION FOR ONEROUS CONTRACTS s

As a consequence of limited revision of AS-29 "Provisions, Contingent Liabilities and Contingent Assets" the scope of this Accounting Standard has been widened to include in its ambit the "Onerous Contract". Now in respect of accounting periods commencing on or after April 01, 2006 Provision for Onerous Contract are required in Accounts.

What is 'Onerous Contract' – An 'Onerous Contract' is a contract in which the unavoidable costs of meeting the obligation under the contract exceed the economic benefits expected to be recovered under it. The Institute of Chartered Accountants of India (ICAI) in Accounting Standards Interpretation (ASI) 30 has illustrated the meaning of 'Onerous Contracts' with this example.

Example: 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.

In this example, the Operating Lease Contract has become onerous as the economic benefit for Lease Contract in next four years shall be NIL and lessee has to pay lease rent for next four years. The provision on account of losses for lease rent payable in next four year is to be provided in the accounts during December 2005 itself. Whereas its was not the position earlier while issuing the AS-29 "Provisions, Contingent Liabilities and Contingent Assets" which became applicable w.e.f. 01.04.2004, such type of 'Onerous Contract' was specifically excluded from the scope of this accounting standard, whereas corresponding IAS/IFRS–37 requires the provision for onerous contract.

The reason for exclusion of provision for 'onerous contracts' as explained by the Institute of Chartered Accountants of India (ICAI) in Appendix-E of the AS-29 was that if provision is made for such onerous contacts it would amount to recognition of future losses in current year's profit and loss account thereby distorting the operating results of the current year. Further it may not be feasible to determine, in all cases, whether a particular contract is onerous or not because which cost are unavoidable may be a matter of judgment. Therefore, the provision of corresponding International Accounting Standards-37 relating to onerous contract was specifically excluded.

However, the reason given by the Institute of Chartered Accountants of India (ICAI) at that time was debatable in view of provision of Para 35 of AS-7 "Construction Contracts" which reads as under:

> ***"When it is probable that total contract cost will exceed total contract revenue, the expected loss should be recognized as an expense immediately"***

This Para of AS–7 "Construction Contracts" requires the provision to be made immediately for "Onerous Contract" thus recognizing the future losses in current year profit & loss account.

Another such instance is valuation of inventories at net realizable value when it is less than cost and the inventories to be sold in future period.

In facts even before limited revision of AS-29, recognition and measurement criteria as laid down in Para 14 of AS-29 were satisfied by the 'Onerous Contracts' but the provision for losses on such contracts could not be recognised in financial statements as AS-29 was not applicable to such contract.

Interpretation ASI-30 issued by the Institute of Chartered Accountants of India (ICAI) clearly acknowledges that the conditions for creating the provision for "Onerous Contract" were satisfied in view of Para 14 of AS-29, which provides as under:

> **"14. A provision should be recognized when:**
> **(a) An enterprise has a present obligation as a result of a past event;**
> **(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and**
> **(c) A reliable estimate can be made of the amount of the obligation.**
> **If these conditions are not met, no provision should be recognized."**

In example given above the provision is required as the conditions are met.

1. **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.

2. **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").

3. **A Reliable Estimate –** A provision is recognized for the best estimate of the unavoidable lease payments.

Even after limited revision of AS-29 wherein 'Onerous Contracts' are brought within the scope of AS-29, the following are still excluded from the scope of AS-29, Para 1 of AS-29 reads as under:

The Statement should be applied in accounting for provision and contingent liabilities and in dealing with contingent assets, except:

a) **Those resulting from financial instrument that are carried at fair value.**
b) **Those resulting from executory contracts, except where the contract is onerous.**
c) **Those arising in insurance enterprise from contracts with policy-holders.**
d) **Those covered by another Accounting Standard.**

If we compare scope of AS-29 with corresponding IAS-37 only (b) & (d) above are excluded, the reason being the (d) "those covered by another accounting standard" covers the (a) & (c) as there are corresponding Accounting Standards on 'Financial Instruments' (IAS-39, IAS-32) and IFRS-4 on insurance contracts. The ICAI has issued exposure draft on "Financial Instruments disclosure & presentation" and must be actively considering issuing the other two also".

The exclusion of executory contract from the scope of AS-29 is in conformity with generally accepted accounting principles as these contracts establish both rights and obligation for each of the contracting party. However where events makes executory contracts as 'Onerous Contract', a liability exist and which shall be recognized.

Limited revision of AS-29 bring the 'Onerous Contract' within its scope is certainly, a good step to make Indian Accounting Standards Compatible with International Accounting Standards and boost the confidence of users of financial statement presented as per Indian GAAP. Distortion of current year profit & loss due to provision for 'Onerous Contract' shall remain a debatable point from accountant angle, however if we look it from the common investors/users perspective, the limited revision in AS-29 will satisfy the expectation of common investors/users and improve the quality of financial reporting.