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NEWSLETTER

Contra Asset & Provision

Chairman's Message

CA SHINE P. JOSEPH
CHAIRMAN

Namaste! Greetings to all!

Respected senior professionals, dear colleagues, friends and beloved students.

When we understand that the effort is in our hands, not the result, we then concern ourselves only with doing our duty; if the result is not to our expectations, we calmly accept it as the will of God. In this way, we are able to accept fame and infamy, success and failure, pleasure and pain, as God's will, and when we learn to embrace both equally, we develop the equanimity. The verse is a very practical solution to the vicissitudes of professional life. In today's competitive environment, every organisation is more concerned about developing the potential of its people than ever before. It is healthy business practice that helps in enhancing the performance and bottom-line results of the organization. Organisations are designing HR policies to achieve their overall objective. These policies include recruitment, training, performance appraisals, motivating employees, as well as workplace communication and workplace safety. Organisations value their human capital to remain competitive and gain an advantage over their competitors.

With the passing of the season of tax audits and tax return filings, I am sure my colleagues will be much relieved and relaxed by now. As it is every year, now is perhaps the time to update ourselves with the new developments in accounting, auditing, and taxation. Even though October was a hectic month, the branch managed to conduct some very good events. On October 25, 2024, we conducted a very important CPE workshop on 'Code of Conduct & Professional Ethics' by CA. Jomon K. George with 3 hours of credit.

The month of October brings with it a season of vibrant festivities, starting from Durga puja till Diwali. There are various festivals that make our lives colourful, enthusiastic, and bring people together. Each of these festivals has its own significance in our lives. I convey my best wishes to all students, members, and their families. May this festival season bring joy, health, and prosperity to all. Diwali is a time to celebrate with family and friends, to reflect on the past year's achievements, and to look forward to a future filled with new opportunities and possibilities. May the glow of Diwali illuminate your path and guide you towards your goals and aspirations. May this festive season bring joy, prosperity, and success into your lives. I extend my warmest wishes to each one of you for all the forthcoming festivals in the month of November.

Details of other upcoming events will be circulated shortly.

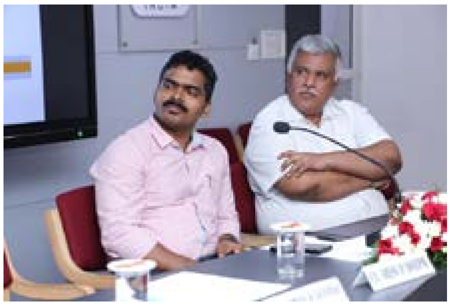
Do not spoil what you have by desiring what you have not; remember that what you now have was once among the things you only hoped for. – Epicurus

A life spent making mistakes is not only more honorable, but more useful than a life spent doing nothing. – George Bernard Shaw

Jai Hind ! Jai ICAI !

CA SHINE P JOSEPH

CPE Seminar on Code of Condut and Professional Ethics & First and Second Ethics of the Chartered Accountants Act, 1949-what members ought to know



Contra Asset & Provision

CA. Allen Alex

Introduction

- The objective of AS 29 (Revised) is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

- Companies would create provisions on arbitrary basis when profits in a particular year is more and then reverse those provisions when profits are lower in subsequent years. This would lead to manipulation of profits. This is popularly known as profit smoothing

- Thus, there is a need for certain parameters on the basis of which provisions are measured and recognised, as they impact both Profit and Loss Statement and Balance Sheet (creation of an expense and creation of a liability).

- AS-29 prescribes the guidance in respect of recognition, measurement and disclosures of provisions, contingent liabilities and contingent assets.

- The standard clearly defines the role of management while making an estimate for creating provisions and the auditors to vouch for the correctness or otherwise of the estimate made by the management. This ensures that manipulations do not take place at the time of creation of provisions

- Earlier, the companies were not recognising the liability on the ground of uncertainty regarding its timing or amount. With the issuance of AS 29, transactions which qualify for creating a provision need to be accounted for in the Balance sheet as a liability

Provision

As per AS 29 Provisions, Contingent Liabilities & Contingent Assets

- Provision is a liability
    - which can be measured only by using a substantial degree of estimation

Liability

As per AS 29 Provisions, Contingent Liabilities & Contingent Assets

- Liability is a
    - present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits

Recognition of Provision

A provision should be recognised when

1. An enterprise has a present obligation as a result of a past event

2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation

and

3. A reliable estimate can be made of the amount of the obligation

4. If these conditions are not met, no provision should be recognised

Present Obligation

An enterprise determines whether a present obligation exists at the balance sheet date

Present Obligation

↓ Exists on Balance Sheet Date → Recognise Provision

↓ Does not Exist on Balance Sheet Date → Disclose Contingent Liability

Past Event

- A past event that leads to a present obligation is called an obligating event
- For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event
- Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future
- Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date
- It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions

Common Examples of Provision

- Provision for Doubtful Debts
- Provision for Employee Benefits
- Provision for Lawsuits and Claims
- Provision for Environmental Obligations

Provision for Doubtful Debts - Liability

- From the bare reading of the AS 29 it is understood that all provision is a liability but is it actually true?
- A prime example is the provision for doubtful debts.
- Here, the entity anticipates potential future losses due to non-payment of outstanding debts.
- By recognizing a provision, the entity adheres to the prudence concept, which necessitates the recognition of expected losses.
- When a provision is charged to the Profit and Loss Account, it essentially reduces the distributable profits.
- This reduction serves as a precautionary measure, ensuring that sufficient funds are set aside to cover potential future losses.
- Consequently, the provision appears as a liability in the balance sheet.
- If the loss materializes, the provision is utilized to offset the loss.
- Conversely, if the loss doesn't occur, the provision may be released, potentially increasing the distributable profits in future periods

Example

Consider a company "ABC Ltd." with outstanding debtors of ₹10,00,000 at the end of the financial year. Based on past experience and current economic conditions, the company estimates that 5% of these debtors may not pay their due

Calculation of Provision

Provision for Doubtful Debts = Outstanding Debtors * Estimated Bad Debt Percentage

Provision for Doubtful Debts = ₹10,00,000 * 5% = ₹50,000

Impact of Financial Statements

Balance Sheet

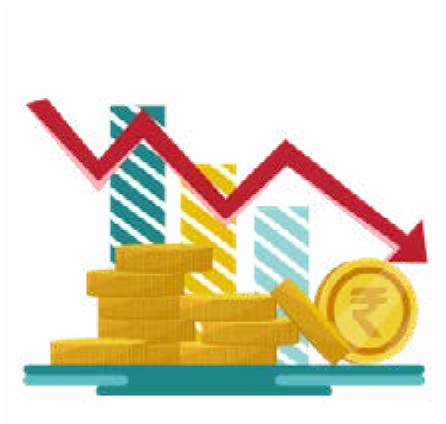
Debtors	₹10,00,000
Less: Provision for Doubtful Debts	(₹50,000)
	₹9,50,000

Income Statement

Profit and Loss Reduced by ₹50,000

Why is it a Liability?

The provision is considered a liability because it represents a potential future outflow of resources. While the exact timing and amount of the loss are uncertain, the company acknowledges the possibility of non-recovery and sets aside funds to cover it. This prudent approach ensures a more accurate representation of the



company's financial position

The Paradox of Provision for Depreciation – Contra Asset

- A common misconception in accounting is the categorization of provisions as liabilities.
- While this holds true for certain provisions like provision for doubtful debts, it doesn't apply universally.
- A prime example is the provision for depreciation.
- The primary purpose of depreciation is to allocate the cost of a tangible asset over its useful life.
- This allocation ensures that the asset's cost is systematically matched with the revenue it generates.
- If we are accounting using provision for depreciation method, then the intention is to maintain asset at original cost.
- Directly reducing the asset's value would violate the fundamental accounting principle of historical cost.
- To reconcile this, we employ a clever technique: creating a provision for depreciation.
- This provision is not a liability in the traditional sense.
- It doesn't represent a future obligation to transfer economic benefits.
- Instead, it's a contra-asset account, reducing the net book value of the asset on the balance sheet.
- By crediting the provision for depreciation account, we effectively recognize the decline in the asset's value without altering its original cost.
- This approach ensures that the matching principle is upheld, while the asset's historical cost remains intact on the balance sheet.

Example

Consider a company "XYZ Ltd." purchases a machine for ₹10,00,000 with an estimated useful life of 5 years and a residual value of ₹2,00,000. The company uses the straight-line method of depreciation

Calculation of Annual Depreciation:

Depreciation Expense = (Cost of Asset - Residual Value) / Useful Life

Depreciation Expense = (₹10,00,000 - ₹2,00,000) / 5 = ₹1,60,000 per year

Impact on Financial Statements

Balance Sheet

Machine	₹10,00,000
Less: Provision for Doubtful Debts	(₹1,60,000)
	₹8,40,000

Income Statement

Profit and Loss Reduced by ₹1,60,000

Why is it a Contra-Asset?

The provision for depreciation is not a liability. It represents the accumulated depreciation charged against the asset. It's a contra-asset because it reduces the carrying value of the asset on the balance sheet, without affecting its original cost. This ensures that the asset is gradually written off over its useful life, reflecting its declining value

Conclusion

In conclusion, while provisions are often classified as liabilities, it's essential to distinguish between different types of provisions. Provision for depreciation, in particular, is a unique case. It's a contra-asset account that helps in accurate financial reporting without compromising the fundamental principles of accounting