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Business Process Solution Alert
Accounting Insights

Discounting of Provisions Reference: Indian Accounting Standard (IAS – 16)

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Background

On 1st April 15 India has introduced roadmap for introduction of Ind AS – Indian Accounting Standard (Converged with IFRS). Ind AS will be applied in a phased manner from 1 April 2016, beginning with companies whose net worth is equal to or exceeding 500 crore INR. Comparative Ind AS information for the year ending 31 March 2016 will also be required. Listed companies and others with a net worth equal to or exceeding 250 crore INR will follow suit starting 1 April 2017. From 1 April 2015, companies covered in phase I of the roadmap will have to look closely into the details of the 39 newly-notified accounting standards. This leaves little time for these companies to put into action an implementation strategy to ensure a successful and smooth Ind AS transition. In this edition we have highlighted the salient features of Discounting of Provisions which is governed under IAS 37 – Provisions, Contingent Liabilities and Contingent Assets.

IAS 37 – PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Discounting of Provisions (Present Value)

IAS37 read as under

“Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation. The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted”

It’s true that IAS 37 does not give us much guidance about how to set the discount rate. It just says that the discount rate should be:

- Pre-tax rate;
- Reflecting current market assessment of the time value of money; and
- Reflecting the risks specific to the liability.

There are more ways to set the appropriate discount rate and let me offer you just one of them:

You can take a government bond rate as a basis. This would be a risk-free and pre-tax rate. Make sure you take bonds with the similar maturity as your liability settlement time (e.g. when you expect to settle the liability in 30 years, then you should take bonds with maturity in 30 years).

If there are no such bonds, then you need to take more issues of government bond with various maturity dates, construct a yield curve and extrapolate along the yield curve to get your own discount rate

How to account for Provision – Journal Entries

There are several events associated with the accounting for provisions:

Recognition of a provision

In most cases, a provision is recognized in profit or loss. Sometimes, a provision is recognized in the cost of another asset, for example, provision for removing the asset and restoring the site after its use.
Don’t forget to split the provision in the current and non-current part for the presentation purposes in your statement of financial position.

Unwinding the discount

When a provision has a long-term nature (beyond 12 months), then there’s some discounting involved as it need to be presented at present value.
In each reporting period, account for an interest on the opening balance of the provision and this is called “unwinding the discount“. The interest is recognized in profit or loss and it also increases the amount of a provision.

Utilization of a provision

When any incur expenditures associated with the settlement of obligation, it is termed as “utilize a provision“. In most cases, provision is simply utilization directly with incurring the invoices from suppliers or any related payments (e.g. Debit Provision / Credit Cash).

Reimbursement

Sometimes, entities have right to reimbursement of related expenditures by the third party (e.g. from an insurance company). In this case, a right to reimbursement is recognized as a separate asset (no netting off with the provision itself), but it can be net off against expenses for provision with the income from reimbursement in the profit or loss.

There can be two type of reimbursements; First the reimbursement is made to company Secondly reimbursements are paid directly to the entity to which company is liable.

When the reimbursement is actually made, Account for Debit Cash Credit Reimbursement Asset. Once company make a payment from this reimbursement, then account for Debit Provision Credit Cash

When the reimbursements are paid directly to the entity to which company is liable "account debit Liability Credit Reimbursement Assets". E.g. when company caused damage to someone else, and company is insured against third party liability, then an insurance company can pay the claim instead of company directly to the damaged entity.

	Debit	Credit
Recognition of Provision	Expense/Assets	Liability – Provision
Unwinding of Provision	Finance Cost	Liability – Provision
Use of Provision	Liability – Provision	Cash/Bank
Reimbursements	Reimbursement Assets	Income

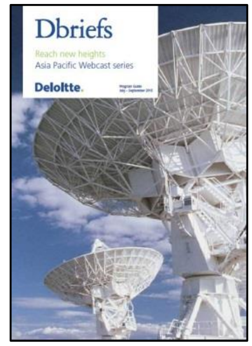
Conclusion

Under existing Accounting Standard Discounting of liabilities is not permitted and provisions are carried at their full values But Ind AS introduces present value of provisions. Under Income –tax Act 1956, Provisions are not allowed but Income Computation and Disclosure Standard recognizes provisions only when they are reasonably certain. Income Computation and Disclosure Standard also requires discounting of provisions similar to Ind AS. Discounting of provisions will have huge impact on profit and loss account as it will record present value of provision in any year then unwinding at each subsequent years. In this alert we have tried to bring more clarity on the recording and measurement of provisions.

Upcoming Dbriefs - Register

How do the New GST Rules Compare: India, Malaysia, and the OECD International VAT Guidelines? Chalk and Cheese?

On 22 September 2015 from 02:30 PM to 03:30 PM IST



In Asia Pacific, there are many new indirect tax systems being introduced. The Malaysian GST went live on 1 April 2015, and India moves forward with a dual GST that may be in force as early as 2016. What are the latest developments in the two countries? Stay current and and out how this may affect the way your business handles cross-border transactions and in-country transactions in both goods and services. For more information, visit the **Dbriefs** page.

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