5 AS 4 = CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

SYNOPSIS

1. Introduction

This standard deals only with Events occurring after the Balance Sheet date. Even though the Standard's name starts with contingencies, all the paragraphs related to 'contingencies' have been withdrawn by ICAI. From 1-4-2004, contingencies are dealt with by AS-29 – "Provisions, Contingent Liabilities and Contingent Assets". Still some contingencies which are not covered by other AS will be covered by this AS.

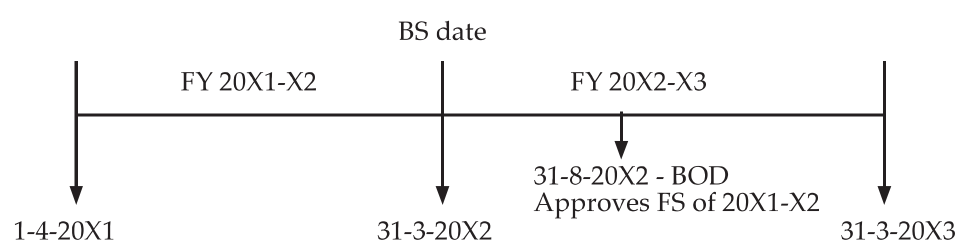
Before we start the main discussion, you need to understand the sequence of approval of financial statements in case of companies.

Step 1: After the financial year end, Board of Directors (BOD)/Management prepare the financial statements and approve the same;

Step 2: Auditor of the company conducts audit and issues a report on the financial statements;

Step 3: Audited financial statements are adopted by the Members of the company in the AGM;

> ***Concept capsule 1***
>
> Who is responsible to prepare the financial statements of an entity and who approves the financial statements?
>
> ***Suggested answer***
>
> Preparation and presentation of financial statements is the responsibility of the management of the entity. Financial statements are approved by the Board of Directors in case of a company; in case of partnership firm, managing partners approve the financial statements, etc.



Look at the above diagram, financial statements of 20X1-20X2 are approved by the approving authority (BOD in case of company) on 31st Aug, 20X2.

Financial statements **approved** means that, the books of account of the financial year are closed. Based on the above diagram, the entity can record any journal entry related to FY 20X1-X2 till 31st Aug., 20X2 only. If an entity identifies any income or expenditure related to FY 20X1-X2 subsequent to 31st Aug., 20X2, that income or expenditure should be recorded in FY 20X2-X3 as a prior period item. ***(Refer AS 5 for more information on this).***

> ***Concept Capsule 2***
>
> The factory is painted in March 20X2, and the painter submitted the bill in April 20X2. The accountant of the company did not make a provision for the expense as on 31-3-20X2. FY 20X1-X2 financials are approved on 30-9-20X2. (a) Can the accountant record the JE for the painting expenses in FY 20X1-X2 OR should he record in 20X2-X3? (b) If the bill is received after 30-09-20X2 what would be the treatment?
>
> ***Suggested Answer***
>
> (a) The expense is incurred during FY 20X1-X2 and it should be recognised as an expense in the same year. Information of the expense is received before the date of approval of financial statements; hence the entity should recognise the transaction as on the balance sheet date, i.e., in FY 20X1-X2.
>
> (b) If the bill is received after 30th Sep, 20X2, it should be recognised as a prior period expense in FY 20X2-X3 as per AS-5. Refer AS 5 – prior period expense for further information.

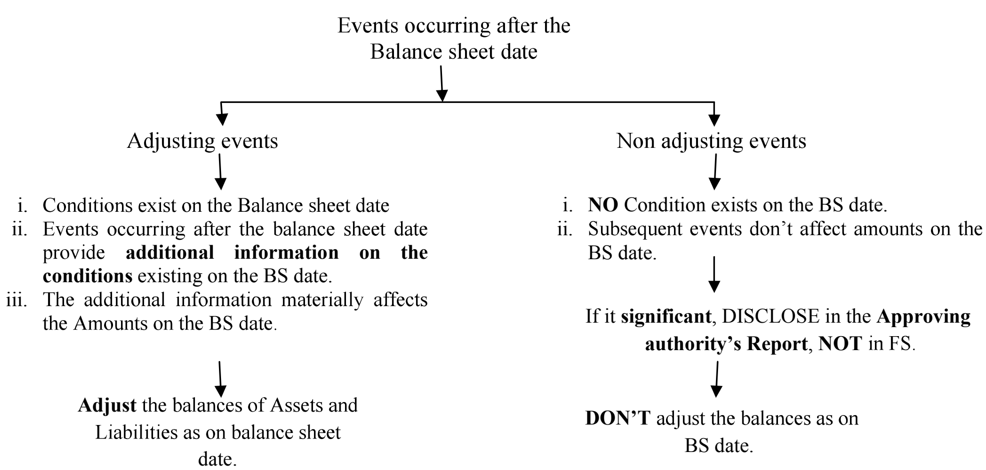
2. Definitions

Events occurring after the balance sheet date: These are ***significant*** events, which occur **between the balance sheet date and financial statements approval date.** These significant events can be favourable or unfavourable to the entity.

Significant events – Material events, which can influence the economic decisions of the users of financial statements.

The whole discussion in this standard is whether the events occurring after the balance sheet date should be recorded as on balance sheet date OR in the next financial year. [e.g. (look at the above diagram) whether it should be recognised in FY 20X1-X2 OR FY 20X2-X3];

Events occurring after the balance sheet date are classified into two, i.e., adjusting events and non-adjusting events; let us understand this concept from the below picture;



> **The primary objective of the standard is to ensure the completeness, that all the transactions and related information should be updated in financial statements.**

3. Important points for noting

Adjusting Events

- Conditions must be existing on the Balance Sheet date;
- The entity doesn't have the complete or correct information about the items on the balance sheet date; If such information was available, the entity could have adjusted (accounted for) accordingly on the balance sheet date only.

- Events occurring after the balance sheet date are confirming or giving more information about the conditions which were existing on the BS date.
- If the subsequent event is an adjusting event, the entity should record the transaction as on balance sheet date. Entity should consider all such adjusting events till the date of approval of financial statements by the approving authority.

Non-Adjusting Events

- No Condition exists on the Balance sheet date;
- Subsequent event doesn't affect the balances as on balance sheet date. So NO need to account for as on balance sheet date;
- Non-adjusting events SHOULD NOT be disclosed in financial statements.
- If non-adjusting events are SIGNIFICANT, **Approving authority** *(like Board of Directors in case of company, Partners in case of partnership firm)* can disclose the same in **their report** *(Board's Report)* so as to enable the users of financial statements to make proper evaluations and decisions. (But not in the notes to financial statements);

The above concepts can be clearly understood with the help of the following concept capsules:

Concept capsule 3

While preparing the financial statements for the year ended 31-3-20X1, X Ltd. made a provision for doubtful debts @ 5% on accounts receivables balance. In Feb, 20X1, a debtor for ₹2 lakh had suffered heavy loss due to an earthquake. The loss of debtor was not covered by any insurance policy. In April, 20X1, the same debtor became insolvent. Financial statements are approved on 30-9-20X1. Discuss the accounting treatment as per AS-4 in the financial statements ended 31st March, 20X1.

Suggested answer

- On 31st March, 20X1, the financial position of the debtor was not good and such condition existed on the balance sheet date. The entity may or may not be sure of the position on the balance sheet date. The subsequent event of insolvency is confirming the financial position of the debtor. So it is an adjusting event and it requires an adjustment to accounts receivable balance by way of making provision for doubtful debts for the entire amount.
- 5% provision may be as per the accounting policy of the company and the above provision should be made in addition to the existing provision.

Concept capsule 4

Continuing with the above question – The accounts receivable balance is ₹2 lakh as on 31-3-20X1. But earthquake took place in April 20X1 and the debtor became insolvent in May 20X1. Discuss the accounting treatment as per AS-4.

Suggested answer

- The debtor's financial position was good as on 31-3-20X1 and the subsequent conditions are entirely different from the balance sheet date condition, i.e., no condition exists. Hence it is a NON-adjusting event and it doesn't require any adjustment to assets as on 31-3-20X1.
- X Ltd. should provide for doubtful debts during the next FY, i.e., 20X1-X2.
- Board of Directors can disclose the same in their report, if it is material to X Ltd.

Concept capsule 5

Continuing with the above question – There was no balance of accounts receivable as on 31-3-20X1 and X Ltd. sold goods in April 20X1 and earthquake took place in May 20X1 and the debtor became insolvent in July 20X1. Discuss the accounting treatment as per AS 4.

Suggested answer

- It is a non-adjusting event and doesn't require any adjustment to assets as on 31-3-20X1;
- X Ltd. should provide for doubtful debts during the next FY i.e. 20X1-X2;
- Board of Directors can disclose the same in their report, if it is material to X Ltd.

Concept capsule 6

A company has filed a legal suit against the debtor from whom ₹ 15 lakh is recoverable as on 31.3.20X1. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 20X1. Can the company provide for full amount of ₹ 15 lakhs as provision for doubtful debts? Discuss.

Suggested answer

As per AS-4, assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date.

In the given case, subsequent information is giving more clarity that the balance as on the balance sheet date is not recoverable hence it is appropriate to make a provision for doubtful debts. Therefore, provision for doubtful debts should be made for the year ended on 31st March, 20X1.

Concept capsule 7

X Ltd. invested ₹100 lakh in Y Ltd. in April 20X1 but the negotiations had started in Jan. 20X1. As per AS-4 - In which financial year X Ltd. should account for the investment?

Suggested answer

AS-4 defines adjusting events as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Approving Authority in the case of a company.

- Negotiations don't amount to conditions. As there are no conditions existing on the balance sheet date, it is a non-adjusting event and doesn't require any adjustment to assets as on 31-3- 20X1, i.e., it should record the investments only in 20X1-X2.
- Investment planning of ₹100 lakh in April, 20X1 in the acquisition of another company should be disclosed in the Director's Report to enable users of financial statements to make proper evaluations and decision.

Concept capsule 8

X Ltd. purchased a building for ₹50 lakh in Jan. 20X1, and the agreement to purchase was concluded in Jan. 20X1. X Ltd's financial year ends on 31st March. In the month of April 20X1, the same building is registered in the name of X Ltd. In which financial year X Ltd. should account for the building?

Suggested answer

Looking at the substance of the transaction, the agreement was concluded in Jan. 20X1 and registration is required for security purpose. The subsequent registration is confirming the agreement. So the building should be recorded in 20X1-X2 only.

Concept capsule 9

X Ltd. holds **current** investments as on 31-3-20X1. Cost of investments is ₹50 lakh and fair market value is ₹55 lakh (on 31-3-20X1) and the company measured it at ₹50 lakh as per AS-13 (i.e., Cost or FMV whichever is less). Financial statements are approved by BODs on 30-09-20X1. Due to subsequent market conditions the value of investments fell down to ₹40 lakh. Whether X Ltd. needs to value the investments at ₹50 lakh or ₹40 lakh on 31-3-20X1? Discuss.

Suggested answer

Market conditions on 31st March are different from 30th Sep. market conditions. The value of investments as on 30th Sep. does NOT affect the conditions on 31st March. Hence it is a **non**-adjusting event and there is no need to adjust the balance on 31-3-20X1 and the value of investments will continue at ₹50 lakh.

I hope you are able to identify adjusting events and non-adjusting events. You can refer some more examples at the end of this chapter.

If the approving authority wants to disclose non-adjusting events in their report, they should disclose the following information:

1. Nature of the events;
2. Estimation of the financial effect;
3. If it is not possible to estimate, disclose the fact that such estimation cannot be made..

Some examples of non-adjusting events:

- Acquisition of a subsidiary OR disposal of a subsidiary;
- Announcing or commencing of major restructuring of business;
- Entering into significant commitments or contingent liabilities;
- Destruction or fire accident in plant after the balance sheet date, etc.

4. Exceptions

Exceptions

Statutory requirement/
Items of Special nature

Events affecting Going
concern assumption.

Exception means **even though it is a non-adjusting event it should be *adjusted* as on balance sheet date.** There are two exceptions to the rule of adjusting events:

1. If it is a STATUTORY requirement OR it is of special nature; (As Accounting standards cannot override the law
2. If events occurring after the balance sheet date affect the GOING CONCERN ASSUMPTION of the entity.
    - By its very nature Accounting Standards cannot override the Statutes (Laws). If any statute requires the accounting in a particular manner, entity should follow the guidance of the Statute. Accounting standard should not be applied in that situation.
    - If any event occurring after the balance sheet date affects the going concern assumption of the entity, such events should be **considered**, and financial statements **should be adjusted** as on the balance sheet date. If the entity doesn't have going concern assumption, it should prepare financial statements on liquidation basis (i.e. NRV) as discussed in AS-1.

***Concept capsule 10* (PROPOSED DIVIDEND)**

On 31-08-20X1, the Board of Directors of X Ltd. proposed dividend of 10% for FY 20X0-X1. Financials of 20X0-X1 are approved by BOD on 30-09-20X1. Discuss the accounting treatment of the proposed dividend as per AS-4.

(CA Inter– Dec 2021 & May 20X1)

Suggested answer

Proposed dividend is an event occurring after the balance sheet date. The company DOESN'T have any liability to pay dividend **on balance sheet date.** The reason being dividend will be a liability to the company only when it is approved by the members of company in the General Meeting. As there are NO conditions existing as on 31-3-20X1, the subsequent proposal for dividend is a NON-adjusting event, **as per the Schedule III proposed dividend information should be disclosed** in the **notes** on accounts separately. (Normally, non-adjusting events are disclosed in approving authority report but not notes – this is an exception to that rule);

Concept capsule 11 ***(CA Inter– Dec 2021)***

After the closure of financial year, i.e., 31-3-20X1, there was a severe earthquake. The company lost its building and major plant and the extent of loss is beyond repair. The company doesn't have adequate funds to replace the same. Discuss your views based on AS-4.

Suggested answer

The subsequent event of earthquake occurred after the balance sheet and no condition exists on balance sheet date. It is a non-adjusting event. Even though the above event occurred after the BS date, the event materially affects the solvency of the company and it indicates clearly that the company is not a going concern. Even though it is not an adjusting event, as per AS-4 – Company has to prepare the financial statements on 31-3-20X1 on NRV basis (liquidation basis) and any gain or loss should be transferred to P&L.

Concept capsule 12

X Ltd. financial statements of 20X1-X2 are approved by the BOD on 30-09-20X2 & financial statements are adopted by the AGM on 15-10-20X2. On 30-11-20X2, the company identified an expenditure (omission of expense) which is relating to 20X1-X2. How to deal with the expenditure? Discuss.

Suggested answer

Once the financial statements are approved by the BOD and adopted by the AGM, the expenditure of 20X1-X2 will be recognised in the P&L of 20X2-X3 as a prior period expense (omission of expense) as per AS-5.
Refer AS 5 for detailed discussion

Questions & Answers

Question No. 1

A company deals in Petroleum products. The sale price of petroleum is fixed by the Government. After the balance sheet date, but before the finalization of the company's accounts, the Government unexpectedly increased the price retrospectively. Can the company account for additional revenue at the close of the year?

Answer

As per AS-4, the unexpected increase in the sale price of petrol by the Government after the balance sheet date cannot be regarded as an adjusting event as it doesn't represent a condition existing as on the balance sheet date. Hence revenue (due to increase in sales price) should be recognized only in the subsequent year with proper disclosure.

Question No. 2

A Company follows April-March as its financial year. The company recognizes **cheques dated** 31st March or before, received after the balance sheet date but before approval of FS by debiting cheques in hand a/c & crediting Debtors a/c. The cheques in hand are shown in the balance sheet as an item of Cash & Cash equivalents. All cheques in hand are presented to bank in the month of April & are also realized in the same month in normal courses after deposit in the Bank. What treatment is correct as per AS-4?

Answer

Even if the cheques bear the date 31st March or before, the cheques received after 31st March **do not represent any** condition existing as on 31st March. It means, it is not an asset under the control of the entity as on the balance sheet date. Hence, there is no situation / condition exist as on 31st March.

Considering the above points, collection of cheques **after** the balance sheet date is NOT an adjusting event. So recognising these as cheques in hand is not consistent with AS-4. Moreover, the collection of cheques after the balance sheet date does not represent any material change or commitments affecting the financial position of the enterprise and therefore no disclosure in the Director's Report are necessary.

Question No. 3 (Need to have little knowledge of AS 7)

A Limited Company closed its accounting year on 30.6.20X1 and the accounts for that period were considered and approved by the board of directors on **20th August, 20X1**. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on **1.9.20X1** it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of₹ 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.20X1.

Answer

In this case the incidence, which was expected to push up cost, became evident after the date of approval(i.e. after 20th August) of the accounts. So, it is not an 'event occurring after the balance sheet date' (it is out of scope of this standard). However, this may be mentioned in the Report of Approving Authority, i.e., Board of Directors report.

Question No. 4 (Read this after AS 29)

IAS Ltd has received a demand notice on 15/6/20X2 for ₹78 lakh from the excise dept in respect of duty payable for several years. The Financial Statements were approved on 31/8/20X2. In July, 20X2, it deposited ₹16 lakh and appealed for ₹62 lakh. Company is expecting to bring down ₹62 lakh claim to ₹27 lakh only (based on its advocate's opinion). How should the company deal with the situation in the financial statements of 20X1-X2?