Provision and Contingent Liability

In the accounting framework, "liability", "provision" and "contingent liability" are terms used to describe an obligation. These terms are widely used across our financial statements. This year, we would like to talk about the underlying accounting concepts behind these terms and their applications, as part of the "Accounting Mini-series" which we first started in our 2006 Annual Report.

What is a liability?

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. A present obligation can stem from a legal agreement (a "legal obligation") or may be constructive in nature (a "constructive obligation"). A constructive obligation arises from an established or published practice of an entity which creates valid expectations on other parties that it will discharge the obligation. A company's policy to compensate dissatisfied customers due to disrupted services is an example of a constructive obligation.

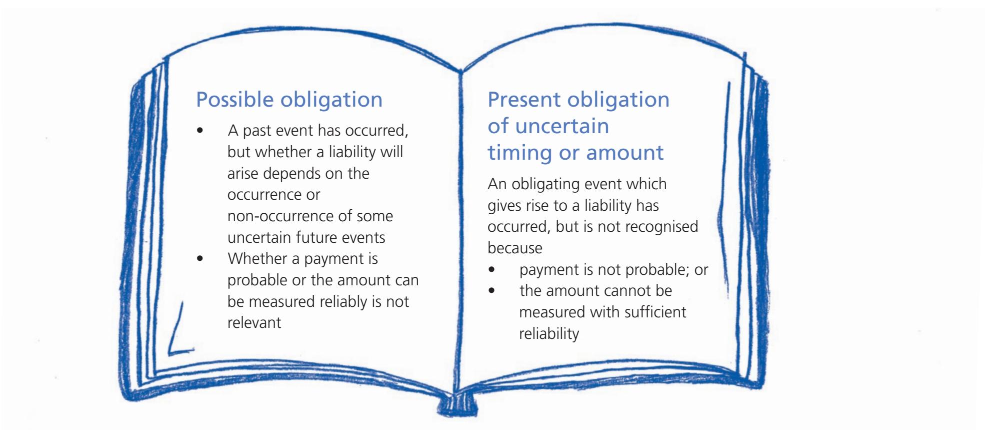
What is the difference between a provision and a liability?

A provision is a sub-class of liability. A provision represents a present obligation that is uncertain in its timing or amount. However, a present obligation that is uncertain in its timing and amount, will still not be recognised as a provision unless it is probable that a future outflow of resources will be required to settle the obligation and that the amount of the obligation can be measured with sufficient reliability.

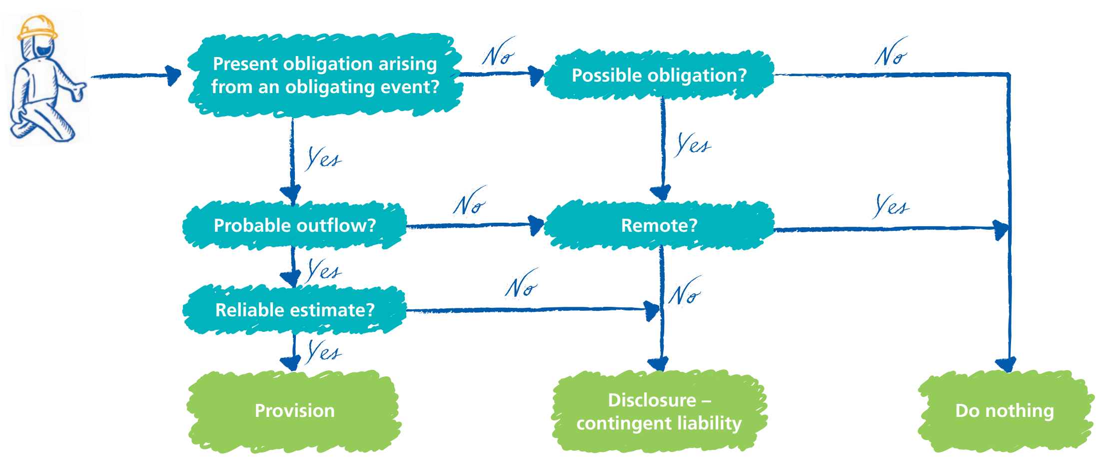
What is a contingent liability?

A contingent liability refers to certain obligations which are not recognised as a liability on the financial statements, but should be disclosed in the note to the accounts.

Such obligations have two types:



The decision tree for recognition of provisions and disclosure of contingent liabilities is illustrated below:



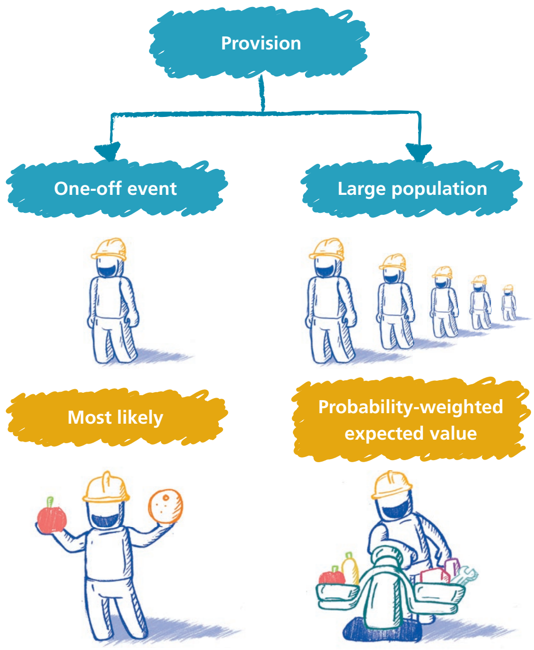
How to measure a provision?

Due to the nature of a provision – a liability whose timing and amount are uncertain, it is difficult to come up with a solid figure. How can we make a reliable provision?

To measure a provision, management should apply the best estimate approach under which the expenditure required to settle the present obligation is estimated based on a likely outcome. Sometimes, reports from experts are required to assist management to make its judgment.

In the case of a large population of items, an expected value method is applied. The estimated amount under this approach will take into account all possible outcomes, weighted by their corresponding probabilities. A typical example of this is a standard warranty provided to customers for the cost of repairs of any defects on goods sold within a certain period of time.

In the case of a single event, the estimate is based on the most likely outcome among all possible scenarios. This method applies to a lawsuit, the outcome of which will be either a win or a loss, but not in between.



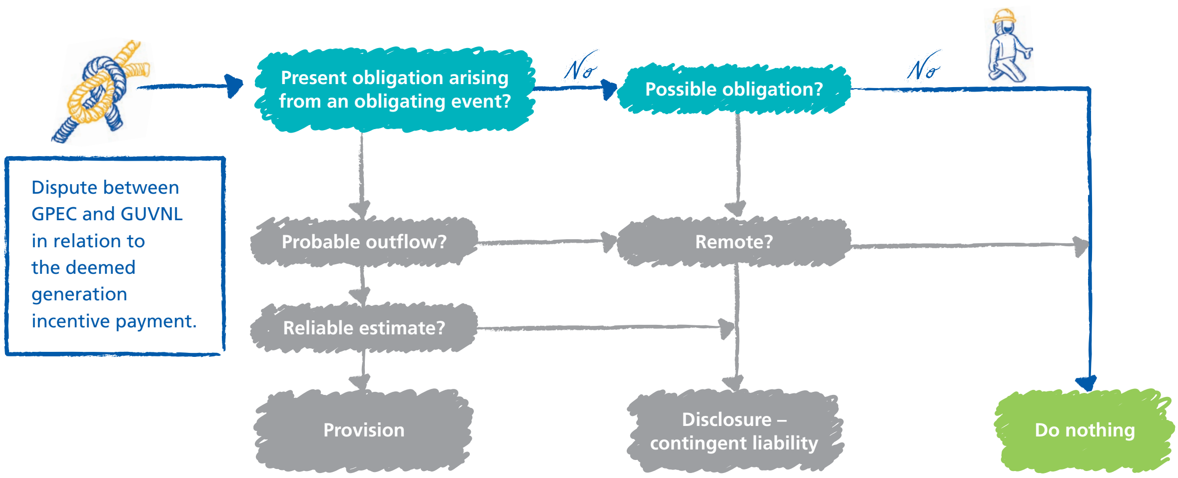
How are these Accounting Concepts applied to our Lawsuit in India?

The dispute

Under the original power purchase agreement between GPEC and its off-taker Gujarat Urja Vikas Nigam Ltd. (GUVNL), GUVNL was required to make "deemed generation incentive" payments to GPEC under certain circumstances. GUVNL had been making such payments since December 1997.

Subsequently, GUVNL raised a dispute about the eligibility of GPEC to receive such payments.

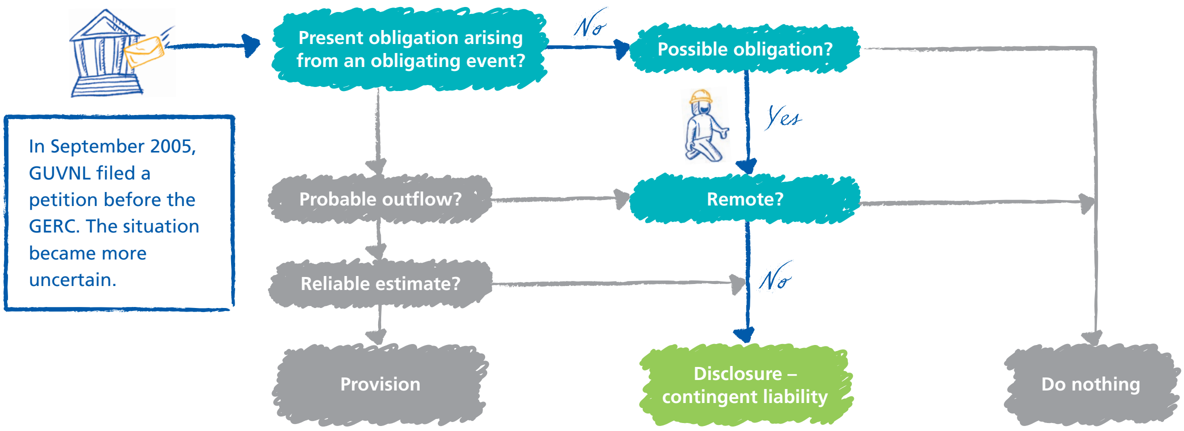
Our assessment was that the payments were required under the terms and conditions of the power purchase agreement and, indeed, GUVNL were continuing to make these payments to GPEC. As such, we were not required to disclose this dispute in our financial statements.



The petition

In September 2005, GUVNL filed a petition before the Gujarat Electricity Regulatory Commission (GERC) against GPEC seeking a refund of the deemed generation incentive payments.

Our assessment, supported by independent legal advice, remained that the payments were due to GPEC. However, with the legality of these payments becoming subject to a decision of the GERC, the situation became uncertain and the results were not fully predictable. A detailed disclosure of the dispute was therefore made in our 2005 Financial Statements.

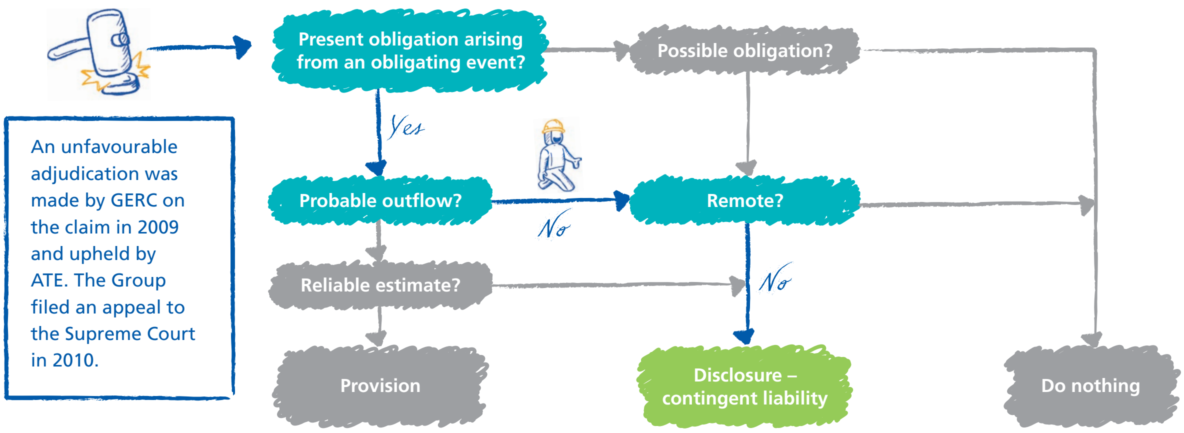


The latest developments

In February 2009, GERC made an adjudication on GUVNL's claims, and ordered that a partial refund of the payments be made by GPEC to GUVNL. GPEC then filed an appeal to the Appellate Tribunal for Electricity (ATE) against the decision of the GERC.

In January 2010, the ATE dismissed GPEC's appeal and upheld the decision of the GERC. GPEC subsequently filed an appeal petition to the Supreme Court of India against the decision of the ATE. The matter was admitted by the Supreme Court on 16 April 2010. The date of hearing has yet to be fixed by the court.

After the decision of the GERC and again after the decision of the ATE, we reconsidered our position. At each stage we remained of the view that the disputed payments are due to GPEC, no new issues had come to light to alter that view and that GPEC is likely to ultimately succeed on appeal to the Supreme Court. That view has been confirmed by independent legal advice. In these circumstances, we concluded that ultimately a requirement to refund GUVNL these deemed generation incentive payments is not probable. As a result, no provision was recognised but a detailed disclosure was set out in a note to our accounts.



Ongoing assessment!

This is not the end of the story. We have to continuously assess whether there are any changes in the circumstances which may affect our current judgment. If the settlement of an obligation becomes probable, we should recognise a liability in the financial statements in the period that the situation changes.