Guide - Provisions in Government Accounting

Background

1. Provisions can be one of the largest balances in government financial statements, so a reliable, accurate and complete presentation (including relevant disclosures) of provisions is crucial to the users of these financial statements.

2. Accounting for provisions is one of the most subjective accounting issues, both on account of the theoretical requirements (**definition and interpretation**) relating to provisions, and to the uncertainty in calculating the amount of a provision ("estimation uncertainty").

3. A liability would be recognised only when the entity is committed in the sense that it has little or no discretion to avoid the sacrifice of future economic benefits.

Purpose

4. This guide provides guidance on theoretical aspects of recognising provisions and how to deal with the calculation or estimation uncertainty in the government sector.

5. Accounting for provisions is a complex topic in government accounting, due to the Australian Accounting Standards (AAS) requirements relating to provisions, and the uncertainty in calculating the amount of a provision ("estimation uncertainty").

Relevant legislation and accounting standards

- *Public Governance, Performance and Accountability (Financial Reporting) Rule 2015 (FRR)*
- *Australian Accounting Standards Board (AASB) standard AASB 137*[1] *Provisions, Contingent Liabilities and Contingent Assets*.

[1] All paragraphs quoted in the paper are in reference to AASB 137.

What are provisions?

6. AASB 137 para. 10 defines provisions[2] as "a liability of uncertain timing or amount".
    a. A liability is defined as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits" (Conceptual Framework for Financial Reporting, repeated in AASB 137 para. 10):
        - An outflow of resources is usually payment of cash, but is not limited only to cash payments.

7. The definition of a liability is critical to the understanding of accounting for provisions.

Other liabilities, contingent liabilities and exclusions

8. In considering provisions it is important to distinguish between provisions, other liabilities and contingent liabilities. AASB 137 paragraphs 11 to 13 provide guidance on this distinction. Other liabilities such as trade payables are different from provisions as there is a **certainty** about their amount and timings.

9. Contingent liabilities are not provisions because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. Contingent liabilities are disclosed in the notes to the financial statement (AASB 137 para. 86). The FRR section 29 requires further disclosures for contingent liabilities and assets.

10. AASB 137 Appendix B has a practical decision tree to help with making a distinction between provisions and contingent liabilities.

11. AASB 137 excludes some items that are generally referred to as provisions such as "provision for doubtful debts" and "provision for depreciation".

    a. It specifically excludes the following from being recorded as a provision under that standard:
        - executory contracts, except onerous contracts (para. 1 a)
        - liabilities that are **not of** uncertain timing or amount (such as creditors and accruals)

[2] In the Australian government sector provisions are broadly put in two categories – employee provisions and non-employee provisions. Some common provision item examples include - employee benefits (superannuation, leave etc.), grant and subsidy (provisions), tax refunds, outstanding benefits and claims, product warranties, legal claims, restructuring costs, decommissioning, make good and restoration costs, product refunds, onerous contracts, future operating costs etc. Employee benefits are covered under AASB 119 Employee Benefits.

- liabilities dealt with under other standards (as set out in paragraphs 1, 2 and 5, but including financial instruments, leases and employee benefits)
- liabilities where there may be a present obligation in future if external events crystallise (this is a contingent liability - see exact wording in para. 10)
- liabilities where a future outflow of resources is not probable (less than 50 per cent chance); or where a reliable estimate cannot be made of the expected outflow (exceedingly rare) (these may be contingent liabilities)
- existing public policy, budget policy, election promises or statements of intent, because they do not represent an obligation that has reached the stage of being binding (para. Aus26.1)
- social welfare payments that might arise in future reporting periods (para. Aus26.1)
- obligations under multi-year policy agreements until the grantee meets conditions such as grant eligibility criteria, or has provided the services or facilities required under the grant agreement (para. Aus26.1).[3] Grants to the States may fall into this category.

12. A provision is defined as a liability of uncertain timing or amount. If both of these elements are materially certain, there may be a liability, but it will not be a provision.
    a. For example trade payables have a high degree of certainty regarding the timing and amount as they have been invoiced and agreed with the supplier. Therefore trade payables[4] are not provisions.

13. If obligations are excluded from being a provision, they may still be a liability that another accounting standard applies to. It is not sufficient that there be an obligation on the government in order to record a provision. An obligation is different from a liability, and not all liabilities result in a provision. All tests as per AASB 137 need to be satisfied before a provision is recognised. As with all accounting issues, materiality also applies.

Recognising a provision

14. To record a provision under AASB 137, all the following elements must be present in the arrangement. These are discussed in more detail later in this guide:
    - There must be an obligation – the government must be committed to do something to the extent that it cannot avoid making payments (or otherwise transferring resources; it need not be cash, even though this is the most frequent occurrence).
    - The obligation must have financial consequences for the entity. For example, an obligation to share legal information with overseas governments would not normally result in a significant payment and consequently would not result in a provision.

[3] Although many such arrangements will be of relatively certain timing or amount, the conditions for a present obligation do not exist.
[4] Additionally, in most cases trade payables would be excluded from AASB 137 because they are financial instruments.

- There must be another party to whom an obligation is owed, although this does not require identification of specific individual parties, but can include general groupings of individual parties (AASB 137 para. 20).
- The financial consequences must be material.

15. AASB 137 para. 14 specifies the recognition criteria and contains three conditions. To recognise a provision all three conditions (discussed below) must be met:

1. An entity has a present obligation (legal or constructive) as a result of a past event (para. 14 a)

A present obligation can arise from:

A. Legal obligation (AASB 137 para. 10)

A legal obligation occurs where there is legislation, a contract or another legally enforceable agreement that requires the entity to make a payment (AASB 137 para. 10). Legal obligation is generally easy to interpret and apply.

In a government benefits payment context the following applies:

- The beneficiary must have met all substantive conditions necessary to qualify for the payment. This is logical because if they don't qualify, they can't get a payment.
- Determining whether a potential beneficiary has met all substantive conditions can sometimes require judgement, and is heavily dependent on the terms and conditions of the program being administered. Therefore it is important that finance staff in entities have a good understanding of the conditions attached to various forms of payment.
- The key factor is whether the beneficiary is legally entitled to have the payment made to them, now or in the future (but see below about present obligations), other than to comply with minor administrative requirements. Examples of minor administrative requirements might include the need for the beneficiary to provide the agency with their email address, or for the agency to publish a document.
- Submission of a valid application would, in many cases, constitute a legal obligation. A valid application is one that has been received and checked to make sure it complies with the conditions. Just making any type of application does not meet this requirement. A process of preliminary registration for a benefit, without having validity checked, is not a legal obligation.
- Similarly, where an application is deemed invalid, but there is a process of appeal or review, it will not constitute a legal obligation until the appeal or review process has been completed to the point where the outcome is certain.
- The implications of delegate approval depend on the precise importance of the approval. If delegate approval is not needed to create a binding obligation, but is in effect an administrative process, there is an obligation. This might occur, for example, where the entitlement of the beneficiary is established by legislation.

However, if a binding obligation is contingent upon receiving a required level of approval, a binding obligation is not created until such time as the delegate's approval occurs. Entities need to understand the extent to which delegate approval is necessary for there to be a binding obligation.

- It is not a specific requirement under AASB 137 that a legal obligation be legally enforced. However, it should be assumed that a legal obligation will be enforceable and will be enforced, in the absence of explicit evidence to the contrary[5]. Where there is doubt about the enforceability of a legal obligation, the doubt would be reflected in the measurement calculation.

B. Constructive obligation (AASB 137 para. 10)

Just because there is no legal obligation does not mean that a provision is not required, because constructive obligations also need to be considered.

A constructive obligation[6] is an obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities (AASB 137 para. 10 definition).

The underlined text is particularly important. If these tests are met there is an obligation (although it might not be a present obligation requiring a provision, see below):

- The standard specifically states that statements of policy, election promises etc. are not obligations (AASB 137 para. 26.1). This is because they do not bind the government to do anything until acted upon – the government is not obligated.
- Often this issue arises with media statements made by ministers. These are not obligations unless there is a binding commitment, and the default position is that there is no binding commitment. For example, if words are used such as "the government has agreed to pay a certain benefit" this might be considered binding if other facts support this. Words such as "the government will consider ways to make payments for a certain benefit" would not be considered binding. These are hypothetical examples only. The exact circumstances of the statement must be considered.
- The terms must be such that the government will have no alternative but to make the payments, as it cannot practically avoid making payment/s at some time.
- In assessing this it should not be assumed that the government will change legislation or policy in future to remove an existing obligation[7].

[5] An example of an unenforceable legal obligation might be one existing in an overseas country that does not have sufficient ability to apply the rule of law.

[6] A common example is where an entity commits to refund of items beyond the existing legal limits in that jurisdiction. Due to this past behaviour (and commitment) there is a constructive obligation on the entity to refund the items and consequently need to have sufficient provision in their financial statements.

[7] Unless such a change has already commenced.

- A constructive obligation can only apply to the individual or group that is expected to meet the conditions to receive payment.

16. No provisions should be recognised for events that will occur after the reporting date or events in future - it is the past events (at reporting date) that create present obligations.

2. *Probable that an outflow of resources embodying economic benefits will be required to settle the obligation* (para. 14 b)

17. For a liability to exist there must be "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits" (para. 10).

18. The wording given emphasis are important to understand and satisfy this condition. A liability and an obligation are not the same thing – a liability is an obligation with the additional feature that it is expected there will be a payment. While it also includes situations that result in an outflow of other types of assets, for government the payment of cash is the most common type of outflow.

19. "Expected" means that it is expected to happen (more likely than not) - there is more than a 50:50 chance that a payment will be required. If the probability is less than 50 per cent, inclusion of a provision in the balance sheet would incorporate situations into government financial statements that are not expected to happen. Key considerations for this process are:
    - Determining an expected outcome requires judgement.
    - Ideally this involves determining the possible outcomes and assigning a probability of each, so that a weighted average expected outcome can be determined. However, it may not always be possible to do this without full information.
    - Entities may take into account a range of factors in exercising judgement, such as the terms of any agreement and past history, none of which are conclusive on their own.

20. Note this is a threshold test, less than 50 per cent probability means no provision. The test is applied to the obligation as a whole, rather than to individual elements. For example, where a policy results in multiple statutory guarantees[8] being issued, the probability test is applied on the overall likelihood of a payment being made, rather than the likelihood of a payment on each guarantee.

[8] Contractual guarantees are accounted for under AASB 9 Financial Instruments.

3. A reliable estimate can be made of the amount of the obligation (AASB 137 para. 14c)

Reliable measurement

21. Recognition of a liability assumes that measurement will be reliable. AASB 137 specifically considers liabilities that have uncertainties. Therefore, it is not an automatic excuse to avoid recording a provision just because there is a degree of uncertainty about the outcome. The uncertainty needs to be so overwhelming that it results in an unreliable measure.

22. In colloquial terms, AASB 137 wants the financial statement preparers to "have a go" at estimating, using the best information that is available. It requires making a **best estimate** of expenditure required to settle the present obligation.

23. Measurement requirements are set out in paragraphs 36 to 50 in AASB 137. These will not be considered in detail, but there are several points worth emphasising. It is important to look at the risks and uncertainties to support the best estimate.

24. While by their very nature, calculation of provisions involves uncertainty, the standard considers that the inability to measure a provision due to uncertainty would be extremely rare. Thus just the existence of uncertainty is not sufficient to prevent recognition of a provision. Reasonable estimates are based on the best available information, management judgement and then supported by adequate disclosure. This is usually sufficient to compensate for uncertainty and follows the best estimate methodology.

25. A broad range of possible outcomes is not sufficient to avoid creating a provision, as AASB 137 includes methods for dealing with this. It should be possible to determine outcomes unless:
    - there is a widely distributed range of possible outcomes; and
    - it is not possible to sufficiently measure the probabilities of possible outcomes, or
    - the range of possible outcomes is not expected to be normally or evenly distributed so that it is not appropriate to simply use the mid-point of the range; and
    - there is confirmation from statistical analysis or other documentation that a reasonable point estimate cannot be made that would represent a reliable estimate of the amount payable[9].

26. It is important to consider and document the reasonableness of management's judgements. If outcomes have been estimated for other purposes, these may provide an indication of the estimated outcome. For example, the costs associated with New Policy Proposals and insurance estimates:
    - actual experience might align with budget estimates, or

[9] For example, development of a demand-driven program for a new policy might have an estimate that does not exhibit evidence of reliability, notwithstanding that a calculation has been made for Budget purposes.

- budget estimates can be checked to equivalent programs to verify estimates, or
- insurance estimates are found to be consistent with accounting requirements.

27. In situations where the cash flows have a material time value of money impact, a present value of the expenditure should be calculated (AASB 137 para. 45).
    - Make sure that either the estimated cash flows are risk-adjusted or the discount rate is risk-adjusted, **but not both and not neither**. Double counting of risk or failing to account for risk results in overstatement or understatement of the provision.

28. Discount rates should reflect the term of the arrangement and the policy towards calculation of risk:
    - If the provision is to cover a liability with an average expected duration of ten years, a discount rate for the most equivalent ten year borrowing would be appropriate.
    - The most frequent practice is that risk is assessed in the cash flows, and then discounted at a risk free rate to reflect the time value of money. However, if risk is not fully covered in the cash flows, risk-free discount rates such as the government bond rate are inappropriate.
    - Entities should not assume that rates contained in other documents, such as in published standard parameters, are applicable to their specific provisions in every instance.

Changes in Provisions (AASB 137 para. 59)

29. Provisions must be reviewed at the end of each reporting period and any changes in probability of outflow of economic resources need to be recognised.

Onerous Contracts (AASB 137 paragraphs 66 to 69)

30. Contractual arrangements where the economic benefits expected to be received are lower than the unavoidable costs of meeting the obligations under the contract are known as onerous contracts. They create present obligations and such obligations should be recognised and measured as provisions.

Significant judgements

31. Accounting for provisions requires judgements to be made. Where these judgements are material, they should be disclosed.

32. Disclosure of judgements does not require detailed disclosure of all assumptions, also it does not always require disclosure of sensitivity analysis. The entity would need to understand the drivers and impacts of sensitivity, to be able to determine how significant a judgement is.

Documentation

33. It is important that entities document all key decisions that are made in calculating provisions, both on:
    - how the criteria for establishing the provision are satisfied, and
    - the assumptions used in the calculations.

34. Documenting how the criteria for establishing the provision are satisfied, should be reviewed each year, to make sure it is still relevant.
    a. For example, checking that there have been no major changes to programs, policies or legislation that affect the nature of obligations. Key practical points to note are:
        - this review is best done before year-end, although if there are subsequent significant changes these will need to be assessed again
        - there should be evidence of the review
        - previous year's documentation of the policy need not be revised, if it is still relevant
        - major changes occurring after year-end but before signing the accounts may require disclosure under AASB 110[10] Events after the Reporting Period.

35. The documentation is an important evidence for audit purposes and it also becomes a good reference point and guide for staff in future years.

Conclusion

36. Provisions are one of the largest line items on government balance sheets. They involve high level of subjectivity and judgement and must be carefully measured and recognised. Hence detailed disclosure including stating relevant assumptions is critical to present a true and fair view of government finances.

37. Entity's proposed approaches in recognising provisions should be agreed with relevant audit teams.

[10] As non-adjusting events, unless they have retrospective application.

38. Accounting Policy at Finance can provide some limited additional information (accountingpolicy@finance.gov.au), but Finance is unable to examine individual cases. So entities may need to obtain independent external advice. AASB 137 appendix C has a number of useful explanatory examples showing application of recognition criteria through common business situations. Finance is also able to provide additional published guidance material and links to publically available advice, on request.

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Appendix A

Examples

Example 1a – Legislative Guarantee

The Government enacts a policy to encourage manufacturing in import replacement industries by guaranteeing loans of up to $100,000. A hundred guarantees will be issued at the start of the year for three years under a legislative instrument. An actuary estimates there is a 2% probability of each guarantee being called annually, with an expected payment of $50,000 if called. The Government bond rate is 2.5%.

As the guarantee is legislative, AASB 137 is applied. The assessment below follows the Decision tree of Appendix B of AASB 137.

Does a liability exist?

- Present obligation: The obligation arises at the time the guarantees are issued.
- Probable economic outflow: 100 guarantees are issued, with a probability of being called of 2% per annum over 3 years, therefore payments are expected to be made on six guarantees.
- Reliable estimate: The expected payment each year is: ***Number of guarantees X probability of being called X Expected payment discounted by Government bond rate***[11]. This is calculated as:

	Year 1	**Year 2**	**Year 3**	**Total Liability**
Number of guarantees	100	98	96	
Probability of being called	2%	2%	2%	
Expected payment	$50,000	$50,000	$50,000	
Government bond rate	2.50%	2.50%	2.50%	
Calculation	(100*2%*50,000)/(1+2.5%)	(98*2%*50,000)/[(1+2.5%)^2]	(96*2%*50,000)/[(1+2.5%)^3]	
Liability	**$97,561**	**$93,278**	**$89,146**	**$279,984**

Posting journal:

DR Other expenses	279,984	
CR Other provisions		279,984

[11] Under AASB 137 paragraph 47, the discount factor should not reflect risks that are factored into cash flow expectations.

Example 1b – Legislative Guarantee:

The Government establishes a similar program as example 1a, but only issues five guarantees over three years. The probability and payment are the same as Example 1a.

Does a liability exist?

- Present obligation: The obligation arises at the time each guarantee is issued.
- Probable economic outflow: Five guarantees are issued, with a probability of being called of 2% each year over 3 years. The likelihood of a payment being made is 5*2%*3 =30%. The probability of payment is less than 50%, so no liability is recognised.

Example 2 – Indemnity Disclosures and Recognition

A Government department provides annual indemnities to directors of a Government Business Enterprise in its portfolio. Indemnities of this type have never resulted in a payment in the past and the probability of a future payment being made is considered remote.

Disclosures

No disclosures are required for remote contingencies as per para. 28 of AASB 137.

Further information comes to light that results in an increase in the probability of payment to greater than remote, but less than probable. The indemnity is now disclosed as a contingent liability.

Recognition as a Provision

The Government seeks legal advice on their potential liability under the indemnity. The advisor estimates that there is a 60% probability of a payment being required under the indemnity. If a payment is made, there is 50% probability it will be $5 million and a 50% probability of it being $10 million.

It is probable that a payment will be made, so a provision is recognised. The amount of the liability is the probability of a payment being made (60%) multiplied by the weighted outcome of the expected payment, 50% $5 million and 50% $10 million:

0.6 * (0.5 * $5 million + 0.5 * $10 million) = $4.5 million

As the indemnities are issued annually, they are not discounted.

A liability of $4.5 million is recognised. Depending on materiality, the assumption used in estimating this figure may also be disclosed.