



FRR 4D Liabilities, Contingencies and Commitments

INTRODUCTION

Policy items, indicated by **shaded bold print**, form the Minimum Reporting Requirements (MRRs).

Pursuant to sections 38(2) and 39(2) of the *Financial and Performance Management Standard 2019* (FPMS), departments and statutory bodies must prepare their financial statements in accordance with the MRRs. All of the MRRs are mandatory for departments. Statutory bodies comply with the FPMS by applying the parts of the MRRs that are considered relevant to their circumstances.

Application Guidance, indicated by plain text under the “Application Guidance” sub-headings, provides support on interpreting and applying the mandatory policy items and other matters.

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4D.1 DISTINCTION BETWEEN COMMITMENTS, LIABILITIES AND
CONTINGENT LIABILITIES

REFERENCES

- *Framework for the Preparation and Presentation of Financial Statements*
- *AASB 101 Presentation of Financial Statements*
- *AASB 137 Provisions, Contingent Liabilities and Contingent Assets*
- *Interpretation 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities*

APPLICATION GUIDANCE

Essential criteria for a liability to exist

An essential characteristic of a liability is that the agency has a present obligation to an external party. The identity of the external party need not be known. The obligation could be to the public at large. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract (for example, with amounts payable for goods and services received) or arise from a statutory requirement.

A liability must be associated with a past event/transaction that gives rise to a present obligation that will result in an outflow from the agency of resources embodying economic benefits. The transaction or event must have occurred.

In most cases, the outflow will be in the form of cash. Settlement of the obligation represented by the liability may also occur in other ways, for example, the transfer of other assets, the provision of services, the replacement of that obligation with another obligation; and conversion of the obligation to equity.

The criteria for recognition will not be affected if the future outflow of economic benefits will be subject to estimation to any degree e.g. a class claim for compensation.

In determining end-of-period accruals, an appropriate materiality level should be set below which accruals need not be recognised.

Allowances for impaired debts, depreciation and impairment are not liabilities or provisions within the definition of a liability under AASB 137. These are treated as a reduction of the relevant asset class.

Distinction between Commitments and Liabilities

Commitments do not give rise to present obligations

Commitments and liabilities arise at separate timing points. Therefore, a key issue is identifying the point at which a commitment becomes a liability. This is important as the recognition of a liability requires the concurrent recognition of an expense or an asset or the reduction of equity. A commitment is not accompanied by a present obligation e.g. merely ordering goods or services would give rise to a commitment but not a present obligation to make a payment. Similarly, a decision by the management of an agency to acquire assets in the future does not, of itself, give rise to a present obligation.

Agreement to commit to a future outflow of resources; but no present obligation

The term 'commitments' is not defined in any accounting standard. Generally, a commitment arises when an entity enters into an agreement with an external party that will result in a future obligation to make an outflow of resources.

Unrecognised contractual commitments

Such agreement would usually be in the form of a purchase order or other contractual documentation. A contractual commitment would be accompanied by, but not limited to, actions taken to determine the amount of the eventual resource outflow or a reliable estimate (e.g. a quote), and confirmation/agreement of conditions to be satisfied to establish an obligation (e.g. delivery schedules).

Budgeting alone not sufficient

These preconditions ensure that the information relating to commitments is relevant and capable of reliable measurement. Without such an agreement a commitment would generally not exist. By way of example, the mere setting aside a portion of a budget for particular expenditure would not be sufficient to constitute a commitment.

In contrast, an agency may enter into a contract before the reporting date for expenditure over subsequent reporting periods, such as a contract for construction of infrastructure, major plant and equipment, or a significant consultancy contract. Even though work has not commenced, and no payments have been made, in this situation, a commitment exists at the reporting date.

A commitment becomes a liability when agreement becomes a present obligation

A commitment becomes a liability when the agreement becomes a present obligation. A present obligation would generally exist if it is probable that the other party would succeed in an action to secure payment or be awarded significant compensation in the event of non-payment i.e. there is little or no discretion to avoid an outlay of funds for work already undertaken, or goods delivered/services provided, by the other party. An irrevocable agreement to acquire goods/services/assets would normally give rise to a present obligation.

Examples of a commitment becoming a liability include when construction of an asset has already commenced, new equipment ordered is received, office supplies ordered are delivered, telecommunication services are invoiced, or external consultants have commenced undertaking their work.

Examples of transaction cycles that may assist in distinguishing between commitments and liabilities are as follows:

Placing a contract out to tender

Stage ----->	Decision to put the contract out to tender	Tender called	Contract accepted and signed	Contract work commenced	Contract work completed	Payment made
Classification --->	No recognition/ No disclosure	No recognition/ No disclosure	Commitment	Liability for work performed. Commitment for unperformed portion	Liability	Liability extinguished

Ordering office furniture or equipment

Stage ----->	Need identified	Quotes obtained	Order placed	Order accepted	Goods delivered / accepted	Payment made
Classification --->	No recognition/ No disclosure	No recognition/ No disclosure	Commitment	Commitment	Liability	Liability extinguished

Payment of Grants

Stage ----->	Conditions set by Government	Application received	Applicant (now 'grantee') advised of success of application	Criteria met by 'grantee' for payment of funds	Payment made
Classification --->	No recognition/ No disclosure	No recognition/ No disclosure	Commitment	Liability	Liability extinguished

Provisions are a Category of Liability

Provisions are a category of liabilities for which the amount or timing of the future outflow is uncertain e.g. provisions for rehabilitation. A provision is recognised as a liability under AASB 137 when, and only when:

- the agency has a present obligation (legal, equitable or constructive) to a third party as a result of a past event;
- it is probable that an outflow of resources will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

If there is any doubt as to whether a present obligation exists, a contingent liability rather than a provision should be disclosed.

Liabilities can only be recognised in respect of past events. Therefore, provisions cannot be created in respect of costs that will need to be incurred to operate in the future. Paragraphs Aus26.1 and Aus26.2 of AASB 137 provide additional guidance on potential liabilities arising from existing Governments' public policies, budget policies, election promises or statements of intent.

Distinction between Contingent Liability and Liability

Contingent liabilities are differentiated from provisions, and therefore liabilities, on the criteria of probability. With a contingent liability, a possibility rather than a probability will exist with respect to the future commitment to the outflow from the entity of resources embodying economic benefits.

Contingent liabilities are disclosed in the notes to the financial statements - they are not recognised as a liability in the Statement of Financial Position. However, a contingent liability may progress to become a provision and require measurement as a liability, even where a degree of uncertainty remains over the amount or timing of the amount to be settled. For example, when a lawsuit is commenced against an agency, a contingent liability will likely exist. If, at balance date, the decision has gone against the agency, but the amount to be paid or the time by which the amount has to be paid is the subject of some uncertainty, the agency must still recognise a provision for the best estimate of the expenditure required to settle the provision at the balance date.

4D.2 ADJUSTING LIABILITIES FOR EVENTS AFTER REPORTING DATE

REFERENCES

- AASB 110 *Events after the Reporting Period*

APPLICATION GUIDANCE

Where an adjusting event occurs that affects a liability that has been disclosed, for example, the amount or timing of a liability has altered or an uncertainty relating to a provision has been removed, then an adjustment to that item is required. Where a future obligation relating to a contingent liability has been confirmed (e.g. a court case is settled after the reporting date and the contingency has previously been disclosed in a note), then a liability or provision will need to be recognised as a provision (even if some uncertainty still exists with respect to the amount or timing of the discharge of the obligation), or as a payable if no uncertainties exist.

Where a non-adjusting event occurs relating to liabilities, for example, the market value of a financial liability changes after the reporting date, no adjustments are made to the financial statements. However, if a non-adjusting event after the reporting date is material, the agency must disclose the nature of the event and an estimate of its financial effect (or a statement that such an estimate cannot be made) for each material category of non-adjusting event.

4D.3 CHANGES IN LONG-TERM PROVISIONS OVER MULTIPLE REPORTING PERIODS AND DATES

REFERENCES

- AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*
- Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*

APPLICATION GUIDANCE

Changes in Provisions

It is not uncommon for the amount estimated to settle a long term provision to vary between reporting periods, and reporting dates, until the specified time of settlement.

In respect of the reviewing provisions at each reporting date, paragraph 60 of AASB 137 provides that where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as a borrowing expense.

For example, assume a present obligation is likely to be settled in 5 years' time at an estimated amount of \$100,000. The provision is recognised at its present value. The Australian Government bond rate for a 5 year period at that time is 5%, so this rate is used as the discount rate. The discount factor of 5% for five years is 0.784. Therefore, the present value of \$100,000 on initial recognition will be $\$100,000 \times 0.784$ i.e. \$78,400.

One year later, expected settlement of the provision will only be four years later. The discount factor of 5% for four years is 0.823. The present value of \$100,000 one year after initial recognition will be $\$100,000 \times 0.823$ i.e. \$82,300.

In terms of paragraph 60 of AASB 137, the difference between the two present values i.e. \$3,900 is recognised as a borrowing expense.

Journal entries would be as follows:

Initial recognition (reporting period one)

Expense	Dr	78,400	
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(classified according to the nature of underlying transaction)

Provision		Cr	78,400
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(Creation of provision: Present Value of \$100,000 in 5 years @ 5%)

One year later (reporting period two)

Borrowing Expense	Dr	3,900	
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Provision		Cr	3,900
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(Borrowing expense: difference between Present Value of \$100,000 @ 5% in 5 years' time vs 4 years' time)

It is unlikely that the discount rate will remain constant over the life of the provision until the time of ultimate settlement. Paragraph 84 of AASB 137 requires a reconciliation to be provided for each class of provision, reconciling the closing carrying amount with the opening carrying amount. One of the elements of the reconciliation is the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

In the example above, if the bond rate had increased to 6% at the end of the second reporting period, then the discount factor for 4 years @ 6% would be 0.792. The net present value of \$100,000 would be $\$100,000 \times 0.792$ i.e. \$79,200. Accordingly, the increase in provision and borrowing expense would be \$800 (i.e. \$79,200 minus the initially recognised \$78,400) and this amount would be disclosed in the reconciliation as required by paragraph 84 of AASB 137.

Reimbursement of Expenditure to Settle a Provision

Paragraph 53 of AASB 137 provides that where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement is to be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.

Dismantling, Removing and Restoring Items of Property, Plant and Equipment

Under AASB 116, where an obligation exists to dismantle and remove an asset or restore the site on which it is located, the cost of the item includes the initial estimate of these costs. An agency incurs this obligation, which may be a legal, contractual or social obligation, either when an item is acquired or as a consequence of having used the item during a particular period for purposes (other than to produce inventories.)

AASB 137 contains requirements on how to measure provisions for decommissioning and restoration of items.

Where the cost of the asset includes the initial estimate of these restoration costs, Interpretation 1 addresses how the effect of the following events that change the measurement of existing decommissioning, restoration or similar liability should be accounted for:

- a change in the estimated outflow of resources embodying economic benefits (e.g. cash flow) required to settle the obligation;
- a change in the current market-based discount rate as defined in paragraph 47 of AASB 137; and
- an increase that reflects the passage of time (also referred to as the unwinding of the discount).

Interpretation 1 applies irrespective of whether the related asset is measured using the cost model or the revaluation model.

Disclosing key assumptions and other sources of estimation uncertainty

AASB 101 paragraph 125 provides that an agency is to disclose in the notes information about the assumptions concerning the future, and other major sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of liabilities within the next annual reporting period. In respect of those liabilities, the notes to the accounts are to include details of their nature and carrying amount as at the end of the reporting period.

Some liabilities e.g. retirement benefit schemes, can only be measured using a substantial degree of estimation e.g. return on fund assets and by making assumptions about future events e.g. movements in interest rates. Should these estimates and/or assumptions prove to be incorrect, then the carrying amount of the liability will be misstated and the liability will either be overstated or understated.

The risks associated with the misstatement increases significantly the more complex and subjective the assumptions and estimates are.

Materiality is a key issue in the application of this disclosure requirement, which has as its focus, liabilities with large carrying amounts and with a high risk of material misstatement should the underlying estimates and assumptions prove to be incorrect.

Agencies with substantial liabilities that have been measured on the basis of complex and/or subjective assumptions and estimates should apply a risk analysis to them. Where there is a high risk of those assumptions and estimates being subject to error or inaccuracy, the agency should assess the impact on the associated liability if the risk was to materialise and disclose the outcome.

Where it is impractical to disclose the extent of the possible effects of changes to the underlying assumptions and estimates made, the agency should disclose that fact and also state that outflows within the next reporting period may be different due to variations to the assumptions made and that this could require a material adjustment to the carrying amount of the liability in future reporting periods.

Liabilities that are measured at fair value at the reporting date are not included in the abovementioned risk group if they are measured at fair value based on recently observed market prices. Such fair values might change materially but these changes would not arise from assumptions or other sources of estimation uncertainty. Disclosure of significant assumptions made in estimating the fair value of financial liabilities that are carried at fair value is covered by AASB 13.

Uncertainties

Agencies are required to disclose uncertainties with regard to each class of provision according to the criteria set out in paragraph 85 of AASB 137. For example, if the government acknowledged that it had an obligation to rectify land degradation and identified an amount that it was prepared to pay, a provision would be created.

The government may be satisfied that, in terms of Commonwealth Government policy, this was an issue of national importance and funding from that level of government was likely. Such anticipated funding would be taken into account in establishing the provision.

4D.4 DISCLOSURE REQUIREMENTS FOR COMMITMENTS

REFERENCES

- AASB 101 *Presentation of Financial Statements*
- AASB 116 *Property Plant and Equipment*
- AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*
- AASB 138 *Intangible Assets*
- AASB 140 *Investment Properties*

POLICY

- **Commitments required to be disclosed by applicable accounting standards must be shown in total for each class of commitment in the following time bands according to the time that is expected to elapse from the reporting date to their expected date of settlement:**
 - **Within twelve months**
 - **twelve months or longer and not longer than five years; and**
 - **longer than five years**
- **The value of commitments disclosed must be inclusive of any GST that will not be recouped by the agency.**