TREASURER'S DIRECTIONS

ACCOUNTING – LIABILITIES

Section A3.3 : Provisions

STATEMENT OF INTENT

Complete and accurate liability information enables an Agency to be fully aware of its financial obligations and the uncertainties expected to affect their ultimate value. This Section explains the requirements for the recognition measurement and disclosure of provisions.

MAIN FEATURES

Section 38 of the *Financial Management Act* requires every Accountable Officer and every employee of an Agency to comply with the Treasurer's Directions.

Provisions

- Provisions are liabilities of uncertain timing or amount.

Recognition of Provisions

- Provisions are to be recognised when: there is a present obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the amount of the provision can be reliably measured, and a separate liability is not otherwise recognised.

Measurement of Provisions

- The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at reporting date.

Disclosure and Management of Provisions

- For each class of provision a detailed reconciliation of the carrying amounts at the beginning and end of the period is to be disclosed in the notes to Agency financial statements.
- Provisions are to be regularly reviewed and recorded amounts revised accordingly.

Reimbursements Against Provisions

- Where an Agency is entitled to recover some or all of the expenditure associated with a recognised provision, the reimbursement is to be recognised as a separate asset where it is virtually certain that the reimbursement will be received if the Agency settles the associated liability.

For authoritative instruction and guidance reference should be made to related Treasurer's Directions and associated commentary, relevant Australian Accounting Standards and other interpretative authorities.

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Appendix A Accounting for Provisions - Examples

AUTHORITIES

Financial Management Act

REFERENCES

AASB 101	Presentation of Financial Statements
AASB 137	Provisions, Contingent Liabilities and Contingent Assets (from 1 July 2008)

Related Treasurer's Directions:

A2.1	Accounting – Assets : Overview
A2.3	Accounting – Assets : Depreciation and Amortisation
A2.7	Accounting – Assets : Receivables
A3.1	Accounting – Liabilities : Overview
A3.4	Accounting – Liabilities: Employee Benefits
A3.6	Accounting – Liabilities : Leases
A3.7	Accounting – Liabilities : Contingent Liabilities
G2.5	Governance – Accountability: Guarantees and Indemnities
A3	Policy Brief – Liabilities Issues 2: Provision for Dividends

WHAT ARE PROVISIONS ?

A3.3.1 **Provisions are liabilities of uncertain timing or amount.**

(i) Provisions are a subset of liabilities distinguished from other liabilities by the degree of uncertainty surrounding the amount or timing of the outflow of resources embodying economic benefits required to settle them. Whilst most liabilities involve some uncertainty (for example, accrued liabilities) this uncertainty is normally insignificant and does not impact materially on the timing or amount of the outflow of resources to be made.

(ii) The existence of a provision is evidenced by a present financial obligation created by a past transaction or event, for which the amount or timing of payment will be reasonably uncertain. For a present financial obligation to exist an Agency must have no realistic alternative but to settle the obligation through the outflow of resources. This element of liability definition is explained in more detail in Treasurer's Directions Section A3.1 Liabilities: Overview.

(iii) Provisions may be required for such items as:

- employee benefits, including: recreation leave and recreation leave loading, where the actual amount and particularly the timing of the payment is uncertain. Treasurer's Directions Section A3.4 Liabilities: Employee Benefits provides further instruction and guidance;
- taxes, for example Fringe Benefits Tax, Payroll Tax and Income Tax (where applicable);
- equitable or constructive obligations, where an event creates valid expectations in third parties, based on past practice, published policy or current statement, that the Agency will discharge the obligation (for example, financial assistance grants to victims of a natural disaster. The liability is recognised only when the amount of financial aid to be provided can be measured reliably);
- onerous contracts, where the unavoidable costs of fulfilling a contract exceed the economic benefits to be received from the contract. These will be rare and will generally involve a guarantee or indemnity (refer to Appendix A, Example 2). Treasurer's Directions Section G2.5 Governance – Accountability: Guarantees and Indemnities provides further instruction and guidance in relation to guarantees and indemnities;
- "make good" requirements under a lease; and
- dividends, where applicable. For further guidance refer to the Policy Brief Liabilities Issue 2: Provision for Dividends.

(iv) The following are not liability provisions as no present financial obligation exists:

- allowance for doubtful debts and accumulated depreciation: these are reductions in the value of the relevant asset classes (contra assets). Further instruction and guidance on doubtful debts and depreciation is provided in Treasurer's Directions Sections A2.7 and A2.3 respectively.
- commitments: are possible obligations that will be confirmed by the occurrence or non-occurrence of one or more uncertain future events. Further guidance on commitments is available in Treasurer's Directions Section A3.1 Liabilities: Overview.
- future operating losses: an expectation of future operating losses is not a liability but rather an indication that an asset or assets may be impaired.

(v) The Liability Decision Tree in Appendix B of Treasurer's Directions Section A3.1 Liabilities: Overview assists in distinguishing provisions from other types of liabilities.

RECOGNITION OF PROVISIONS

A3.3.2 **Agencies are to recognise provisions:**

- **when it has a present obligation as a result of a past event;**
- **when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation;**
- **where the amount of the provision can be reliably measured; and**
- **where a separate liability is not otherwise recognised.**

(i) A provision is probable when it is more likely than not that an outflow of resources embodying economic benefits will be required to settle the obligation.

(ii) Appendix A presents examples of provisions and their accounting treatment. In the first example, fringe benefit tax is recognised as a provision and not another liability. While the tax expense and its timing are certain, the amount can only be estimated because the tax is expensed before the returns are prepared. The estimate of the expense is sufficiently reliable to classify it as a provision and not a contingent liability.

(iii) Where a number of similar obligations exist, the probability that a settlement will be required is determined by considering the class of obligations as a whole. For example, indemnities are usually disclosed as contingent liabilities, but where a claim has been made against an individual indemnity, an agency should assess the likelihood of similar claims arising in the future for that class of indemnities. An immaterial claim against a single indemnity may multiply to a material claim across the class. Where it is more likely than not that such claims will occur across the class, then a provision is recognised for the best estimate of the costs of making good claims for the class of indemnities identified.

MEASUREMENT OF PROVISIONS

A3.3.3 **The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the reporting date.**

(i) Reliable measurement in the case of provisions is more difficult than with other liabilities due to the degree of uncertainty in measurement or timing inherent in their nature. The use of estimates is an essential part of recording provisions and does not undermine the reliability of the measurement.

(ii) The best estimate of the expenditure required to settle the present obligation is the amount that an agency would rationally pay to settle the obligation or to transfer it to a third party. Determining a best estimate requires judgement, having regard to similar transactions, and, where appropriate, advice from independent experts.

(iii) Where more than one expenditure outcome is possible, the most likely outcome may be the best estimate of the liability. Alternatively, the obligation can be estimated by weighing all possible outcomes by their associated probabilities. Provisions for long service leave are calculated using the latter process.

(iv) Factors to consider when measuring a provision include:

- the degree of uncertainty in amount or timing of the underlying liability (a high level of uncertainty does not justify an excessive or overstated provision);
- discounting provisions where the time value of money is material using a discount rate that reflects the time value of money;
- taking future events into account where there is sufficient evidence that they will occur (for example, known legislative and technological changes); and
- excluding gains from the expected disposal of an asset, even if there is a close link between asset disposal and the event giving rise to the provision. For example, consider the situation where an Agency (the lessee) recognises a provision for a "make good" clause of a lease agreement on vacating office premises. In vacating the premises the lessor has agreed to purchase some of the office fit-outs/furniture. In measuring the value of the provision an Agency must not offset any expected gains from disposal of the office assets.

(v) In rare circumstances the degree of uncertainty as to the amount or timing of a provision is so great as to prevent reliable measurement of the provision. The provision is then classified as a contingent liability and it is only disclosed in the notes to the Agency financial statements. Treasurer's Directions Section A3.7 Liabilities: Contingent Liabilities provides further instruction and guidance in relation to contingent liabilities.

DISCLOSURE AND MANAGEMENT OF PROVISIONS

A3.3.4 **An Agency must disclose in the accounting policy note accompanying the Agency's financial statements its policy on recognition and measurement of provisions as required by AASB 101 Presentation of Financial Statements.**

A3.3.5 **An Agency should disclose specific qualitative and quantitative information in the notes to its financial statements as required by AASB 137 Provisions, Contingent Liabilities and Contingent Assets.**

(i) For each class of provisions, an Agency shall disclose the following quantitative and qualitative information:

Quantitative

- the carrying amount at the beginning and end of the period;
- additional provisions made in the period, including increases to existing provisions;
- amounts used (incurred and charged against the provision) during the period;
- unused amounts reversed during the period; and
- 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.

Qualitative

- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits; and
- an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an Agency shall disclose the major assumptions made concerning future events.

For further guidance refer to Appendix A of Treasurer's Directions R2.1: Agency Financial Statements.

(ii) In determining which provisions may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the qualitative requirements of A3.3.5(i) above.

A3.3.6 **Provisions are to be regularly reviewed and recorded amounts revised, where necessary, to reflect the best estimate of the liability at the time of the review.**

(i) Over time the uncertainties associated with provisions change. As such, Agencies are required to review provisions on a regular basis. The regularity of reviews should be determined based on the size and nature of the underlying provision and

the potential to have a material impact on an Agency's Financial Statements. Ideally, reviews of all liabilities should be conducted monthly to assist in ensuring that whole of Government reporting is accurate.

(ii) Where a future sacrifice of economic benefits is no longer probable, a previously recognised provision will no longer be recognised and recorded by an Agency.

(iii) The recorded value of a provision may also be reduced by a sacrifice of economic benefits (for example, a cash payment) made during a reporting period against that particular provision.

(iv) Examples of journals recognising, adjusting and removing provisions from Agency financial statements are provided in Appendix A.

REIMBURSEMENTS AGAINST PROVISIONS

A3.3.7 **Where an Agency is entitled to recover some or all of the expenditure associated with a recognised provision, the reimbursement is to be recognised as a separate asset where it is virtually certain that the reimbursement will be received if the Agency settles the associated liability. The amount recognised for the reimbursement shall not exceed the amount of the provision.**

A3.3.8 **In the income statement, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.**

(i) On occasion an Agency may have a right to receive all or part of the economic benefits required to settle a provision from a third party (for example through a supplier's warranty). In such cases the other party may either reimburse amounts paid by an Agency, or pay the amounts directly to the creditor. In most situations an Agency will remain liable for the full provision as it will have to fulfil the obligation if the third party fails to make a repayment.

(ii) An Agency should only recognise an asset receivable and associated revenue, equivalent to the amount expected to be received from the third party, in such instances where it is virtually certain that the recovery amount will be received if the Agency settles the liability underlying the associated provision.

(iii) Where an Agency recognises a provision and is expected to receive output revenue from Government in relation to this provision, an asset receivable is not to be recognised in this context.

APPENDIX A

ACCOUNTING FOR PROVISIONS – EXAMPLES

Example 1 – Provision for Fringe Benefits Tax

An Agency determines it has a Fringe Benefit Tax (FBT) liability but is uncertain of the exact amount, as no return has yet been prepared. Journal entries are required to recognise the estimated FBT liability and expense for the period. The Agency estimates its provision for FBT to be $7,000 for the period based on its taxable fringe benefit related expenditure for the period.

DR	Fringe Benefits Tax Expense	*(Increase in Expenses – Statement of Comprehensive Income)*	$7,000	
CR	Provision for Fringe Benefits Tax	*(Increase in Liabilities – Balance Sheet)*		$7,000

In the next period, the level of taxable type expenditure increases (due to an increase in employees entitled to this type of benefit) and the provision for the period is estimated at $15,000.

DR	Fringe Benefits Tax Expense	*(Increase in Expenses – Statement of Comprehensive Income)*	$8,000	
CR	Provision for Fringe Benefits Tax	*(Increase in Liabilities – Balance Sheet)*		$8,000

Shortly thereafter, the Agency's FBT return is prepared and it is discovered that the Agency's actual liability is $16,000. This amount is then paid.

DR	Provision for Fringe Benefits Tax	*(Decrease in Liabilities – Balance Sheet)*	$15,000	
DR	Fringe Benefits Tax Expense	*(Increase in Expenses – Statement of Comprehensive Income)*	$1,000	
CR	Cash at Bank	*(Decrease in Assets – Balance Sheet)*		$16,000

Alternatively, if the Agency had over provided for FBT by $1,000 (actual liability $14,000) the final journal entry would be:

DR	Provision for Fringe Benefits Tax	*(Decrease in Liabilities – Balance Sheet)*	$15,000	
CR	Fringe Benefits Tax Expense	*(Decrease in Expenses – Statement of Comprehensive Income)*		$1,000
CR	Cash at Bank	*(Decrease in Assets – Balance Sheet)*		$14,000

APPENDIX A (continued)

Example 2 – Onerous Contract

An Agency has entered into a 4 year supply purchase contract. To make the arrangement economically viable for the supplier, the contract provided a guarantee to the supplier (appropriately approved under the *Financial Management Act*) that the Agency would either purchase or pay for a certain quantity of the supplies over the period (known as a take or pay commitment).

In the first year the Agency is confident that it will need at least the guaranteed amount, probably more, therefore there is no requirement to raise a provision.

Before the end of the second year there is a major advancement in the field in which the supplies are used with the result that within 6 months (year 3 of the contract) it is more likely than not that the Agency will have access to a better method of fulfilling its requirements and its needs for the supplies will diminish. As the Agency is contractually committed under the take or pay arrangement a provision, equivalent to the supplies not required but guaranteed, will be required. In this example the following is assumed:

	Year 2	Year 3	Year 4
Guaranteed Amount	$200,000	$200,000	$200,000
Agency revised estimated usage	$230,000	$110,000	$20,000
Payment under guarantee	Nil	$90,000	$180, 000

The Agency is required to raise a total provision and associated expense for $270,000 at the time when it realises the contract is onerous. The journal entries at this time are (Note: future liabilities and expenses are not discounted in this example):

DR	Purchase of Goods and Services	*(Increase in Expenses – Statement of Comprehensive Income)*	$270,000	
CR	Provisions - Other	*(Increase in Liabilities – Balance Sheet)*		$270,000

If at any stage the Agency revises its usage estimated, the provision should be adjusted accordingly. When the time came to end the contract and pay out the guarantee, the following journal entries would be required.

DR	Provisions - Other	*(Decrease in Liabilities – Balance Sheet)*	$270,000	
CR	Cash at Bank	*(Decrease in Assets – Balance Sheet)*		$270,000

Note: This is an extreme example and should not occur or be minimised through proper management and risk assessment by an Agency.