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Accounting for and Reporting Liabilities

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PREFACE

The objective of the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) is to develop programs aimed at improving public sector financial management and accountability. To that end, the IFAC PSC issues Guidelines, Statements on Practice and Studies. Studies are undertaken by the Committee to provide information that contributes to public sector financial reporting, accounting or auditing knowledge.

In March 1991, the IFAC PSC issued Study 1, *Financial Reporting by National Governments*. That Study considered the objectives of the financial reports of national governments and their major units, and the extent to which those objectives are met by different bases of accounting and different reporting models.

In July 1993, the IFAC PSC issued Study 2, *Elements of the Financial Statements of National Governments*. That Study identified the elements of financial statements (that is, the types or classes of information that may be reported in financial statements), and considered the extent to which those elements would be reported under different bases of accounting. The Study noted the implications of reporting particular elements or sub-sets thereof for the messages communicated by financial statements and the achievement of the objectives identified in Study 1.

This Study develops upon Study 1 and in particular on Study 2. It is a companion to Study 5, *Definition and Recognition of Assets*, both of which examine in greater detail accounting and reporting issues related to specific elements of the financial statements. This Study identifies and explores current views held internationally on:

(i) the definition and classification of liabilities;

(ii) the effect of different bases of accounting on accounting for and reporting liabilities; and

(iii) the particular issues and problems arising from certain types of liabilities.

A wide variety of views exist about whether, when and how certain liabilities should be measured and reported. IFAC PSC hopes that this Study will contribute to the debate about these issues. The Study seeks to compare the differing views expressed with the user needs identified in Study 1 and Study 2, and then to indicate the direction of changes to good practice to best inform both users of the financial reports and decision makers in the public sector.

Major revision of public sector accounting is taking place in various parts of the world and readers should be aware that references from different countries reflects the state of current practice and standards at a point in time.

Some countries have moved to adopt accrual accounting for the non-business public sector, which would include recognition of all liabilities. Whether or not a country adopts accrual accounting for its assets, however, it is important to be aware of a government's liabilities and other potential obligations arising from a government's commitments and contingencies because they significantly impact a government's financial flexibility.

The IFAC PSC hopes that this Study will act to encourage readers, whether or not they are members of the accounting professions, to consider alternative approaches to the definition and recognition of liabilities and contribute to international developments which will lead to improvements to financial reporting by public sector entities and greater comparability of financial reports both between and within different jurisdictions.

Accounting for and Reporting Liabilities

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CHAPTER 1

INTRODUCTION

Purpose of the Study

.001 This Study examines the concepts, principles and issues related to accounting for and reporting liabilities in the general purpose financial statements of national governments and other non-business public sector entities. The Study will identify and discuss:

(i) the definition and classification of liabilities;

(ii) the effect of different bases of accounting on the definition, recognition and reporting of liabilities; and

(iii) the particular issues and problems arising from certain types of liabilities.

Scope of the Study

.002 Consistent with IFAC Public Sector Committee (IFAC PSC) Study 1, *Financial Reporting by National Governments,* and Study 2, *Elements of the Financial Statement of National Governments,* the primary focus of this Study is on the financial statements prepared for national governments and for the entities or units they establish for the delivery of goods and services and the achievement of government objectives. Nevertheless, the matters the Study addresses may be equally applicable for other levels of government (state, provincial and local governments)[1]. In fact, the Figures in the Study reflect practices in a variety of public sector organizations. For example, the information for Australia reflects practices in the New South Wales Government and the national Department of Finance because the national government has not yet produced accrual financial statements.

Need for the Study

.003 Historically, governments have tended to focus on their outstanding debt as a primary measure of the government's liabilities or indebtedness, particularly in formulating or assessing economic policy. Yet, governments have assumed a variety of commitments and obligations that give rise to other liabilities or exposure to potential liabilities. In many cases, major liabilities are unreported by governments. However, information about all of a government's liabilities and exposure to potential liabilities is vital if governments are to manage their cash flow and make informed decisions about the financing of future services and resource allocation.

.004 Concepts about liabilities developed in the private sector pose some interesting issues when applied to governments. While governments have obligations arising from liabilities similar to business enterprises (e.g., trade payables, debt and employee pension obligations), they also have a host of other potential obligations, such as recurring commitments under established social programs, guarantees and promises made by politicians. Drawing a line between liabilities on the one hand, and commitments and contingencies on the other, can be difficult. Further, there is debate on the extent to which they should be recognized in government financial statements. Chapter 2 explores the definitions of these terms and the differences between them. Chapter 4 discusses the recognition of liabilities and Chapter 5 the reporting of contingencies and commitments.

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1 Readers should note that accounting for government-owned business enterprises is addressed in International Public Sector Guideline 1, which directs them to follow the International Accounting Standards promulgated by the International Accounting Standards Committee.

.005 Governments also face challenges in estimating the extent of some obligations because of measurement uncertainties. For example, there is not yet consensus in all countries on the appropriate basis for measuring liabilities related to employee pension obligations, let alone national pension schemes for citizens.

Context of Previous Studies

.006 This Study is one of a series of studies that examines government financial reporting practices and trends in them.

.007 The IFAC PSC's Study 1, *Financial Reporting by National Governments,* set the stage for this series of studies. It identifies the objectives of the financial reports of national governments and their major units, and examines the degree to which those objectives are met by different bases of accounting and reporting models.

.008 Study 1 concluded that the overriding objective of financial reporting is to communicate reliable information that is relevant to the accountability and decision making needs of the users. It also notes that the broad objective encompasses a number of specific goals including: communicating information about compliance with spending mandates, the financing of activities, financial condition and various aspects of the performance[1].

.009 Study 1 also describes alternative accounting bases that could be adopted by governments, ranging from the cash basis to the full accrual basis. The Study highlights four points on the continuum that represent bases of accounting that are currently adopted by different governments:

- cash;
- modified cash;
- modified accrual; and
- full accrual.

.010 These four bases will be referred to in this Study to demonstrate the impact of different bases of accounting on the recognition of liabilities.

.011 IFAC PSC's Study 2, *Elements of the Financial Statements of National Governments*, considers how the elements of financial statements (e.g., assets, liabilities, revenues, expenses/expenditures and net assets) are defined, and the sets, or subsets, of the elements that would be reported, under the different bases of accounting. It also explores the implications of reporting particular elements, or subsets thereof, for the messages communicated by financial statements and the achievement of the objectives identified in Study 1.

.012 Based on Studies 1 and 2, IFAC PSC now plans to undertake studies that explore different perspectives and approaches to accounting for and reporting specific elements of government financial statements. This Study on liabilities is a companion to Study 5, *Definition and Recognition of Assets.* Using the framework established in IFAC PSC Studies 1 and 2 (in particular, alternative accounting bases), this Study explores the breadth of liabilities governments and other public sector entities possess, identifies similarities to and differences from liabilities in the private sector, and examines the issues for financial reporting arising from the differences.

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[1] See IFAC PSC Study 1 or Appendix 1 of IFAC PSC Study 2 for a full discussion of the objectives.

CHAPTER 2

DEFINITION OF LIABILITIES IN THE PUBLIC SECTOR

IASC definition of a liability

.013 The International Accounting Standards Committee (IASC) has defined a liability as:

"a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

.014 Based on the IASC definition, the IFAC PSC Study 2 (Elements Study) identifies certain fundamental characteristics of liabilities:

(i) *the existence of a present obligation arising from past events. That is, a transaction or other event in the past has given rise to a "duty or responsibility" to a third party which has not yet been satisfied.*

(ii) *liabilities have adverse financial consequences for the reporting entity. That is, the entity is required to incur additional liabilities, or dispose of cash or other assets to one or more entities, to settle the obligation.*

.015 Figure 2.1 summarizes definitions of liabilities in existing accounting pronouncements and in practice internationally. While certain jurisdictions have not formally defined liabilities, most have established specific practices or policies.

.016 A review of the definitions reveals that virtually all include the broad characteristics of a liability outlined in Study 2.

Problems in applying the IASC definition to governments

.017 The definition of a liability that is appropriate depends to a certain extent on the basis of accounting adopted by the government. Obviously, under a cash basis of accounting, liabilities are not recognized and a definition is not needed. Nevertheless, as is illustrated in Chapter 4 in the discussion of the recognition of liabilities, once some form of accrual accounting is adopted, the types of liabilities recognized, and therefore, the definition that is appropriate, will be similar.

.018 While in a broad sense, the two characteristics of liabilities identified in Study 2 apply to governments, there are complex issues in applying them to the breadth of governments' obligations that might be considered liabilities for financial reporting purposes.

.019 Most people agree that legally enforceable obligations, such as those arising from binding contracts, are liabilities of a government. Such obligations may exist as a result of reciprocal or "exchange" transactions (e.g., purchases of goods or services), or unpaid amounts due under nonreciprocal or "nonexchange" transactions (e.g., grants or entitlements). In the extreme, it could be argued that governments have the power to avoid any obligation because they have the power to change the law and can give it retroactive effect, thereby nullifying contracts or eliminating the right to recourse. But if government financial reports are to be useful, it is necessary to view them from the perspective of the ordinary course of events.

Figure 2.1

COMPARISON OF DEFINITIONS OF A LIABILITY

COUNTRY	**DEFINITION**
Australia	Liabilities are the future sacrifices of service potential or future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. *(Statement of Accounting Concepts 4, ¶46 and AAS 29, Financial Reporting by Government Departments)*
Canada	Liabilities are financial obligations to outside organizations and individuals as a result of transactions and events on or before the accounting date. They are the result of contracts, agreements and legislation in force at the accounting date that require the government to repay borrowings or to pay for goods and services acquired or provided prior to the accounting date. They also include transfer payments due even where no value is received directly in return. *(Public Sector Accounting and Auditing Handbook, Section PS 1500 ¶ .37, 1986)*
Italy	No specific definition given. However, the recognition criteria for liabilities provide the relevant characteristics.
Netherlands	No formal definition exists. In practice, all commitments of a year lead to a liability item in the trial balance of that year and subsequently to an item in the state balance sheet, if not settled at the balance sheet's date . The commitments regarding the public debt (payments, repayments and interest) are stated in the national operating statement and in the operating statement and trial balance of the Ministry of Finance only.
New Zealand	Liabilities are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. *(NZSA Statement of Concepts for General Purpose Financial Reporting, 1993, ¶ 7.10)*
Taiwan	No clear definition is provided in the Law of Accounting, Budget Law or Annual Reporting Law. In practice, liabilities refer to obligations incurred on past transactions or other events for which amounts can be reasonably measured and will be paid by using economic resources or by providing services.
United Kingdom	A liability is an obligation to transfer economic benefits as a result of past transactions or events. *(ASB, FRS 5 "Reporting the Substance of Transactions")*
United States	A liability is a probable future outflow or other sacrifice of resources as a result of past transactions or events. *(Statement of Recommended Accounting Standards #4, "Accounting for Liabilities of the Federal Government", 1995)*

.020 Nevertheless, there may be debate on when specific legally enforceable obligations give rise to liabilities. It may not always be straightforward to decide which “event” will give rise to recognition of a liability, even when there is a contract or agreement.

.021 In addition to legally enforceable obligations, Study 2 also notes that "equitable" or "constructive" obligations could be liabilities under a broader interpretation of the characteristics.

.022 Business enterprises can identify their "equitable" or "constructive" liabilities relatively easily. Such liabilities may arise from normal business practice, custom, or a desire to maintain good business relations or be seen to be acting equitably. For example, a business may regularly replace faulty products or perform repairs after the warranty period. The nature and extent of such liabilities have relatively clear limits.

.023 Governments cannot as easily put reasonable limits on their "equitable" or "constructive" obligations because those limits may be disputed by citizens who have a broader view of those obligations. Governments have broad responsibility to provide for the public’s general welfare. Most governments have established programs to fulfill many of the general needs of the public and often assume responsibilities for which they have no prior legal obligation.

.024 Citizens, however, may expect the government to accept responsibility for a broad range of obligations for which the government has not yet acknowledged responsibility. Governments may not be able to fulfill all of the public’s expectations. For example, in times of recession, governments must make tough economic choices and past policies and practices may not continue. Even though a government has accepted a moral or equitable obligation to provide relief to victims of a natural disaster in the past, the economic environment may limit the government's ability to do so in the future. Whether or not such obligations can be considered liabilities depends, at least to a certain extent, on economic conditions. It may also depend on the social and political environment and other factors which affect the government’s ability to avoid the obligation.

.025 On the other hand, in some circumstances, it may be reasonable to expect the government to be responsible for certain obligations of public sector organizations, even though there may not be a formal guarantee or legal requirement. For example, an unfunded pension liability in an organization that, while outside of the government reporting entity, is virtually financial dependent on the government, could be argued to be a moral obligation of the government that should be recognized as a contingency, at a minimum, and perhaps as a liability of the government.

.026 Even if one accepts that the government must acknowledge its obligation in such circumstances, it is unclear what could constitute acknowledgment. Does the announcement of a new program or other spending commit the government, or does that announcement have to be reflected in approved legislation or law?

.027 In Westminster-style parliamentary governments, some have argued that no liability should be recognized until the expenditure has been approved by the parliament through appropriations legislation — that is the basis for parliamentary control. It has even been argued that it is "illegal" to do so. On this basis, some governments recognize only "funded" liabilities, or those liabilities which have been provided for in the government's annual appropriation.

.028 An argument often put forward supporting this view is that because governments have the power to tax, recognition of certain liabilities can reasonably be deferred in order to match recognition of them with future revenues. In fact, in recognizing the liabilities, governments may feel obliged, or even required, to raise taxes to meet those liabilities — even though payment for them may not be due until well into the future. For example, some governments may be required by legislation to “balance their budgets” each year — i.e., to raise sufficient revenues to meet all operating costs. It is argued that, under these circumstances, liabilities should not be recognized in the accounts until revenues need to be raised in order to meet them. However, while such accounting may be appropriate for a funding plan, failing to report liabilities in the government’s financial statements may mean that they are not adequately taken into account when making decisions about what the government can or cannot afford to do.

.029 It is often further argued that the government of the day cannot commit a future government and so obligations that may continue into the future should not be reflected in the government of the day's financial reports. However, any such "commitment" that does not contravene the country's constitution is likely to be upheld. Thus, while a government cannot spend the money without parliamentary approval, it often cannot renounce the obligation without a lawsuit. Arguably then, the government's financial statements should report long-term liabilities, even though they will be paid by a future government.

.030 Nevertheless, there is clearly a need to consider some more specific criteria that will provide reasonable boundaries for the breadth of obligations that should be recognized as liabilities in a government's financial statements.

Additional considerations for government liabilities

.031 It can be argued that, in the government context, the existence of a present obligation arising from past events occurs only when there is a legal obligation. The legal obligation could be the result of contracts, agreements or legislation that commit the government, for example, to repay borrowings; or to pay for goods and services acquired or provided prior to the accounting date; to provide services or use resources in a specified way; or to make transfer payments, even where no value is received directly in return (e.g., entitlements, shared cost agreements or grants). Usually, an external party has a legal right of recourse if the government fails to meet the terms of the contracts, agreements or legislation.

.032 Building on that concept, two additional criteria may be useful in assessing the difference between legal obligations and policy decisions:

- whether or not the government has the discretion to avoid the obligation; and
- whether or not the government can vary its liability without the consent of the party affected.

.033 As a practical example, consider the difference between employee pension obligations and national pension schemes. Employee pension obligations are usually legal obligations that are part of a negotiated compensation package. The obligations cannot be avoided by the government nor can they be changed without the consent of employees and/or their unions. On the other hand, national pension schemes are usually legislated policy decisions that can be changed by the government through amending legislation without the consent of third parties.

.034 In the absence of a clear legal responsibility, the existence of an obligation for which the government may have a liability must be assessed on the basis of available evidence. In situations such as these, estimates may be necessary in determining not only the amount to be paid in settlement of an obligation, but also the expectation that payment would be made.

Drawing the line between liabilities, contingencies and commitments

.035 It is often difficult to distinguish between liabilities, contingencies and commitments. In the following sections, contingencies and commitments are defined and their differences discussed.

Contingencies

.036 The IASC defines contingencies in International Accounting Standard 10 as:

"A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be confirmed only on the occurrence, or non-occurrence, of one or more uncertain future events."

.037 Most of definitions in Figure 2.2 embody similar characteristics:

(i) a condition, situation or circumstance that exists that involves uncertainty.

(ii) the outcome of the uncertainty will be resolved in the future.

.038 Examples of contingencies are claims, pending or threatened litigation, guarantees of the indebtedness of others, indemnities and provisions related to self-insurance programs.

.039 What distinguishes a liability from a contingency is the uncertainty related to its existence. It is not simply uncertainty in and of itself that distinguishes a contingent liability from a liability as there may be considerable uncertainty about the measurement of certain liabilities. Indeed, some liabilities can be measured only by using a substantial degree of estimation, such as liabilities for employee pension obligations. But in that case, it is the measurement of the existing obligation that involves certain assumptions and estimation. In the case of a contingency, it is the event or events creating the obligation that is uncertain, in addition to any measurement uncertainty.

.040 The distinction between a liability and a contingency is no more complex for governments than it is for business enterprises. What is contentious is the point at which a government should report a provision for loss arising from a contingency, such as a loan guarantee and whether or not a reliable estimate can be made of that loss. This is discussed further in Chapter 5.

Commitments

.041 The IASC does not have a formal definition of a commitment, although commitments are discussed in the IASC's *Framework for the Preparation and Presentation of Financial Statements* (Framework) in distinguishing between a liability and a future commitment. IAS 5 on *Information to be Disclosed in Financial Statements* also requires disclosure of amounts committed for future capital expenditure (such as minimum lease payments).

.042 The Framework distinguishes between a present obligation (a liability) and a future commitment, which of itself does not give rise to a present obligation. For example, when an entity enters into a commitment (contract) to purchase or construct a capital asset in the future, an obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation leaves the government with little, if any, discretion to avoid the outflow of resources to another party.

.043 Figure 2.3 shows that, for the most part, the definition of commitments used in the public sector are usually either based on common usage or have evolved in practice rather than being considered in formal pronouncements. But in those countries that do define commitments, the definitions vary significantly.

.044 For example, Canada's Public Sector Accounting and Auditing Board defines financial commitments as obligations that become liabilities if and when terms of existing contracts, agreements or legislation are met. Other countries, such as the United States and New Zealand also relate commitments to obligations under long-term contracts and undelivered orders.

Figure 2.2

COMPARISON OF DEFINITIONS OF A CONTINGENCY

COUNTRY	DEFINITION
Australia	No specific definition is given. However, they are referred to as a liability that has failed to meet the recognition criteria of (a) it is probable that the future sacrifice of economic benefits will be required, and (b) the amount of the liability can be measured reliably. *(Proposed Australian Accounting Standard, Financial Reporting by Governments, ¶ .93, ED 62, March 1995)*
Canada	Contingencies are the result of existing conditions or situations involving uncertainty that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm... the loss or impairment of an asset or the incurrence of a liability. Contingencies result from such matters as pending or threatened litigation, guarantees of the indebtedness of others, indemnities and provisions related to insurance programs. *(Public Sector Accounting and Auditing Handbook, Section PS 1500 ¶.59, 1986)*
Italy	No specific definition is given. However, the recognition criteria for contingencies provide the relevant characteristics.
Netherlands	No formal definition exists. In practice contingencies are unforeseen circumstances and conditional events that might influence the valuation of capital assets and/or that might lead to a provision in the balance sheet.
New Zealand	The term "contingency" used in this Statement is restricted to a particular condition or situation which exists at balance date the ultimate outcome of which will be confirmed only on the occurrence, or non-occurrence, of one or more uncertain future events after the time of completion of the financial statements. It does not include general or unspecified business risks or conditions.*(NZSA SSAP 15 (1982), ¶ 3.1)* Contingent liability, in relation to any person,-- (a) Means a liability that, by reason of something done by a person, will necessarily arise or come into being in relation to that person if one or more certain events occur or do not occur; but (b) Does not include a liability, or category of liabilities, described in the Third Schedule to this Act. *(s.2(1) the Public Finance Act 1989)*
Taiwan	No formal definition exists. SFAS No. 9, *Contingencies and Subsequent Events*, issued for business enterprises, provides some guidance.
United Kingdom	A contingency is a condition which exists at the balance sheet date, where the outcome will be confirmed only on the occurrence or non-occurrence of one or more uncertain future events. A contingent gain or loss is a gain or loss dependent on a contingency. (SSAP 18, *Accounting for Contingencies*)
United States	A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. *(Statement of Recommended Accounting Standards #4, "Accounting for Liabilities of the Federal Government", 1995)*

Figure 2.3

COMPARISON OF DEFINITIONS OF A COMMITMENT

COUNTRY	DEFINITION
Australia	There is no widely accepted definition of a commitment.
Canada	Financial commitments are obligations to outside organizations or individuals that become liabilities if and when terms of existing contracts, agreements or legislation are met. *(Public Sector Accounting and Auditing Handbook, Section PS 1500 ¶ .55, 1986)*
Italy	No specific definition exists. In general it is assumed that the commitment takes place when the government engages the obligation of a payment; this obligation gives rise to a provision of funds to cover expenditures in the future. According to a more correct definition, a commitment can be considered the allocation of money to a reserve fund for future expenditures as foreseen by the government. The allocation involves, unless it is removed, the non availability of the amounts to other destinations.
Netherlands	A commitment of a certain year is estimated as the amount of the commitment arisen in that year, directly based on a treaty, an act of parliament, a royal decree, a ministerial regulation, an order or an undertaking which will or may lead to an expenditure in that year or in a subsequent year. *(Dutch Government Accounts Act, Article 4, subsection 5)* In practice a commitment is a judicial and/or economical action or event that will lead to a future expenditure.
New Zealand	Commitment means future payments and expenditure to be incurred on contracts that have been entered into at a balance date. *(Public Finance Act 1989).*
Taiwan	No formal definition exists.
United Kingdom	There is no statutory definition of a commitment, and the expression is interpreted in accordance with common usage.
United States	Commitments have not been officially defined for financial reporting but in practice they are reported. On page 30 of the prototype Consolidated Financial Statements 1992 (unaudited), footnote 19 describes commitments as long-term contracts for which appropriations have not been provided by the Congress and undelivered orders that represent obligations. From a budgetary perspective, commitments have been defined as an administrative reservation of an allotment or of other funds in anticipation of their obligation.

.045 Italy, on the other hand, considers a commitment to be an allocation of money to a reserve fund for future expenditures so that the funds are not available for other uses.

.046 As used in the context of business enterprises, commitments are clearly distinct from liabilities in that there are conditions to be fulfilled in a future period. While the entity is reasonably certain to ultimately incur the liability at some future time, there are conditions or events that will trigger the liability.

.047 Contingencies are different from commitments in that the government's responsibility is contingent on an uncertain future event; whereas with commitments, the government's responsibility for the future liability exists at the reporting date based on a contractual agreement. To put it simply, with contingencies there is uncertainty as to whether a future liability will arise, whereas with commitments there is more certainty that the liability will arise albeit at a future time.

.048 The line between a liability and a commitment can be very blurry for governments. While the distinction is relatively clear under a contractual obligation, it may not be as straightforward when the commitment is embodied in legislation.

.049 Study 2 notes, for example, that similar to a business enterprise's decision to acquire an asset, formal adoption of a budget, the passing of appropriation legislation, the establishment of a grant program or the expression of a general undertaking to expend funds to provide services, do not constitute liabilities. Yet, under some legislation, events may occur that give rise to a stream of future payments.

.050 Consider, for example, the creation of a statutory program for social benefits. Such programs inevitably create a stream of future payments. For example, the government may have a program to provide temporary assistance to unemployed persons. When an individual becomes unemployed, it may be possible to estimate the amounts that will be paid to them based on past experience. Yet, would it be a liability to the government, or does the program merely create a commitment to provide such assistance? At any point in time, the government is only obliged to pay for amounts owed to the individual at that point in time under the terms of the legislation. Such amounts would likely meet the definition of a liability. However, the individual's right to ongoing payments depends on certain criteria, such as, in the case of unemployment assistance, continuing to be unemployed and their ongoing availability for work. Such amounts are not liabilities because they depend on future events.

.051 Similar arguments could be made for welfare assistance to those who cannot provide for basic housing, clothing and food, or for assistance given to the elderly. In both of these cases, however, the assistance is likely to be less temporary than with an unemployment insurance scheme. Nevertheless, there are certain criteria that recipients must meet in order to continue to be eligible to receive payment. While there is a commitment under the program, the government's liability is limited to amounts owed at a point in time under the terms of the legislation. In a sense, the legislation creates the "contract" with the individual or organization and defines the performance criteria that must be met in order to continue to receive payment. Further support for the argument that the liability is limited to amounts actually owing at a point in time is that most programs established by the government can be changed without the consent of the parties affected. The government has the authority to create and change legislation.

.052 It may also be difficult to determine the substance or nature of accident compensation schemes that may be provided by governments. The arrangements for such schemes vary but usually provide for some reimbursement of lost income as well as costs of rehabilitation to workers who are injured on the job. If a claim is approved, arguably there is a liability for related costs already incurred. Certainly known pensions for victims or beneficiaries are likely to meet the tests to be considered liabilities and should be accounted for as such. But is there a liability, or a commitment, for anticipated future payouts related to that claim (which could be measured on an actuarial basis)? In a sense, the question relates to whether the scheme is, in substance, an insurance scheme or a welfare program.

.053 From one perspective, an important difference between these types of programs or schemes and employee pension plans is that they are available to citizens at large, whereas, in the case of employee pension obligations, the obligation is to specific individuals. That distinction may influence not only the measurement of the liability or commitment, but also its recognition.

.054 Another argument is that the government's intention is to pay for these benefits through future revenues. Therefore, while the government may have a legitimate interest in forecasting expected payments over the long-term, the amounts may be of little use in day-to-day management decisions, particularly in operating departments. In enacting legislation to create such programs, the government assumes, not liabilities, but obligations. Since the government also implicitly assumes the obligation to raise tax revenues to finance the programs, reporting one without the other could be misleading. Projections of general obligations and projections of the resources to cover them may better be left to budget documents.

.055 Governments may also have agreements or settlements that will be paid over a certain number of years. For example, both the federal and provincial governments in Canada have recently settled a number of aboriginal claims. Those settlements often involve large payments over a future period. At a minimum, the government has a commitment, but is there a liability for the full amount of the settlement when the agreement is made, or in each year according to the agreed payment pattern? The federal government in Canada now records liabilities for all aboriginal claims settled based on the present value of the settlement amounts, even though they may be made over a number of future years. Identifying long and short term components of such liabilities may also be useful.

.056 In each case, it is useful to refer back to the characteristics of the liability outlined above — Does the government have any discretion to avoid the obligation? Can the government vary its liability without the consent of the party affected? Does payment depend on any future events? Another useful perspective is to consider whether the other party or parties involved could reasonably be considered to have a corresponding asset.

CHAPTER 3

TYPES AND CLASSIFICATION OF LIABILITIES

Types of liabilities

.057 The types of liabilities that governments may report include:

- accounts payable arising from the purchases of goods and services;
- accrued interest payable;
- accrued salaries and wages;
- accrued vested vacation pay or other accrued compensated absences;
- employee pension obligations and other accrued employee benefits, including any accrued termination benefits;
- amounts payable under guarantees and indemnities where events and amounts have become certain;
- deferred or unearned revenue (where amounts have been received but have not yet met the revenue recognition criteria, such as where there are restrictions on use of resources);
- transfer payments payable;
- currency issued;
- lease obligations related to capital leases; and
- borrowings
  - bank loans and other short term borrowings;
  - long term debt; and
  - loans and advances payable to other levels of government or government entities.

.058 Most of these liabilities are similar to those of business enterprises and, therefore, do not inherently pose unique accounting or reporting issues for governments.

.059 Liabilities that are unique to governments would include government transfers payable and currency issued.

.060 Government transfers payable arise from entitlements, shared cost or grants where there is not a direct exchange relationship with the recipient. In concept, the related liabilities are not significantly different from other accounts payable. It is the recognition criterion that is unique because there is not a direct exchange relationship.

.061 Governments who consolidate their central banks would also record their currency issued as a liability. This would be similar to banks who record deposits as liabilities.

.062 Whether or not a government recognizes any of these liabilities depends on the basis of accounting employed, as discussed in Chapter 4.

Classification of liabilities

.063 In general terms, issues related to the classification of liabilities are not as complex as for the classification of assets. The significance of the classifications is affected by the basis of accounting, both in the types of liabilities recognized and in the objectives appropriate to the basis of accounting used. Classification is only an issue, under those bases of accounting that recognize liabilities and in particular those bases that recognize long term liabilities (see the discussion of recognition under different bases of accounting in Chapter 4).

Groupings

.064 In the broadest sense, similar liabilities are usually classified into meaningful groupings. For example, a number of different accounts payable or accrued liabilities may be grouped. Liabilities related to employment might be grouped under employee entitlements. A typical segregation by main classification might be:

- accounts payable and accrued liabilities;
- employee pension obligations or entitlements;
- unearned revenue;
- debt; and
- loans and advances from other governments.

.065 Because of the nature and size of the government's borrowings, it can reasonably be anticipated that debt will be highlighted. Because of the exposure to changing exchange rates, it is also important to distinguish debt payable in foreign currency whenever its amount is significant.

Classification

.066 Beyond such straight forward groupings, the presentation of liabilities involves a process of sub-classification. Liabilities may be grouped by nature or function. As all liabilities are inherently financial, there is not a debate about presenting financial liabilities distinct from other liabilities as there is for assets.

.067 Normally in private sector financial reports, liabilities or groups of liabilities are often displayed in some perceived hierarchy of liquidity, i.e., the expected timing of the related outflow of economic resources. Business enterprises are usually required to identify current liabilities so that working capital (current assets less current liabilities) can be readily calculated. Identifying current assets and liabilities is intended to give an approximate measure of the entity's liquidity, that is, its ability to carry on its activities on a day to day basis without encountering financial stringencies. That is usually interpreted as being expected to be realized within one year or within the normal operating cycle of the entity, whichever is longer.

.068 Some governments have followed a similar pattern by identifying current or non-current liabilities. New Zealand makes this distinction, for example, as does New South Wales in Australia.

.069 IAS 13 notes, however, that the segregation of assets and liabilities between current and non-current is usually not considered appropriate in the financial statements of enterprises with indeterminate or very long operating cycles. It is not clear what the "operating cycle" of the government is in the same sense as a manufacturing enterprise. Nevertheless, the financial cycle of a government is usually associated with the fiscal year, as most governments operate under the authority of an annual budget. Accordingly, governments may want to distinguish between those liabilities that will probably be met in the upcoming budget period, from those that will be met in future periods.

.070 Many governments make no attempt to classify their liabilities at all, except by main category. Others may separately identify those liabilities that are "special purpose", in the sense that there is an identifiable revenue stream other than general taxation that will meet those obligations.

.071 There is no inherently best way to classify a government's liabilities. The key is to display information in the manner that is most useful to users for purposes of making economic decisions.

CHAPTER 4

RECOGNITION OF LIABILITIES

Recognition criteria for liabilities

.072 Study 2 states that:

"Under the IASC framework, determining which items should be recognized in the financial statements as assets and liabilities involves the following two steps:

(i) determining whether the item meets the definition of an asset or a liability; and

(ii) determining whether the item satisfies the recognition criteria."

.073 Chapter 2 discusses the first criterion — meeting the definition of a liability. Study 2 outlines the recognition criteria for liabilities according to the IASC Framework. Under the Framework, liabilities should be recognized when:

"...it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably."

.074 Figure 4.1 shows the recognition criteria adopted by different countries. Most definitions refer to similar recognition criteria:

(i) the future outflow or sacrifice of economic resources (including service potential) is probable.

(ii) the amount is measurable.

.075 Note that Italy requires that the expenditures have been approved or authorized in the governmental budget before they can be recognized as liabilities. Canada also includes authorization in its recognition criteria for government transfers. To a certain extent this is a compliance issue. In many countries, expenditures cannot be made without the approval of government. Therefore, theoretically, a liability cannot be incurred without the expressed approval of the government. In a Westminster-style parliament, this is the essence of parliamentary control. In some countries, a distinction is made between funded or unfunded liabilities — the difference being whether or not resources to discharge those liabilities have been provided for in a budget appropriation.

.076 The risk is that liabilities that represent real claims on the government's resources may be excluded from the government's financial reports. Many governmental budgets are prepared on a cash basis. The budget may, therefore, reflect the extent to which a liability, such as employee pension/superannuation obligations, is being funded in the year, but not the change in the government's liability itself. If the budget focusses only on cash flow expenditures that are anticipated to be incurred in the upcoming year, many large, accumulating liabilities will not be captured and may go unrecorded.

.077 Recognizing liabilities on the basis of budget authorization could also result in commitments being reported as liabilities. In some accounting systems, every purchase order placed or other commitment is recorded to show the extent to which authorized amounts have been used. Thus, if carried through to the financial statements at the end of the period, amounts reported as liabilities may include both accounts payable and "encumbrances" — that is, unfilled commitments. This accounting basis can be used to manage results reported merely by varying the decision as the extent to which unspent budgetary authority is deemed to have lapsed.

Figure 4.1

COMPARISON OF RECOGNITION CRITERIA FOR LIABILITIES

COUNTRY	RECOGNITION
Australia	A liability shall be recognized in the statement of financial position when and only when: • it is probable that the future sacrifice of service potential or future economic benefits will be required; and • the amount of the liability can be measured reliably.
Canada	No general recognition criteria for liabilities have been recommended for governments in the general reporting framework for governments. It is assumed that recognition would be dependent on meeting the definition of a liability. Recommendations have been given for recognition of liabilities arising from government transfers, which include that a reasonable estimate of the amount can be made, that the transfer is authorized and that eligibility criteria, if any, have been met by the recipient. The need for a reasonable estimate is also inherent in the stated qualitative characteristic of reliability. *(Public Sector Accounting and Auditing Handbook, Section PS 3410, 1990; and Section PS 1400, 1984)*
Italy	No liabilities should be recognized or accounted for until the expenditures have been approved or authorized within governmental budget. Only those liabilities that give rise to an outflow of resources to a specific period of time are recognized.
Netherlands	No formal recognition criteria exist.
New Zealand	A liability shall be recognized in the statement of financial position when and only when: • it is probable that the future sacrifice of service potential or economic benefits will be required; and • the amount of the liability can be measured with reliability. *(NZSA Statement of Concepts for General Purpose Financial Reporting, 1993, ¶ 7.14)*
Taiwan	No formal criteria for recognition are provided. SFAS No. 1 is used as a basis for recognizing liabilities.
United Kingdom	Entities should recognize all material liabilities. Materiality thresholds may vary from body to body and type of transaction, and no standard guidance has been issued.
United States	The criteria for recognition is a probable and measurable future outflow or other sacrifice of resources arising from: • past exchange transactions, • government-related injuries or damages, or • nonexchange amounts that, according to current law or applicable policy, are unpaid amounts due as of the reporting date. *(Statement of Recommended Accounting Standards #4, "Accounting for Liabilities of the Federal Government", 1995)*

.078 From another point of view, authorization may be argued to be the criterion that distinguishes a liability from a promise. While a government representative may announce the government's intention to provide certain payments (e.g., grants to compensate farmers or fisherman for extraordinary losses), it may only be the governing party's plan until the legislature or government as a whole has accepted the commitment when it approves its spending plan. It could be argued, however, that the other criteria are sufficient to address this issue because, even if measurable, there may not be reasonable assurance that the future outflow of resources is probable until the grant or program is approved by the government.

Recognition under different bases of accounting

.079 The nature and type of the liabilities that may be recognized in the financial reports will differ depending on the basis of accounting adopted. As discussed earlier, the basis of accounting for governments will lie in a spectrum from the cash basis to the full accrual basis.

.080 Figure 4.2 summarizes recognition of liabilities under the four bases of accounting identified in Study 1 and further expanded upon in Study 2.

.081 At least to a certain degree, variations in liabilities reported under different bases of accounting will not be as pronounced as for assets. Once some accrual accounting is adopted, it is more difficult to draw the line between which liabilities will be reported and which will not than it is for assets.

.082 As a general rule, as one moves along the spectrum towards full accrual accounting, it is likely that obligations to be settled further into the future will be recognized as liabilities.

Cash Basis

.083 Under a pure cash basis, liabilities are not reported at all since expenditures are only reported as cash is disbursed. Only those "liabilities" that have been paid during the year would be recognized in the financial statements and included in expenditures. So, for example, only funding payments to employee pension or superannuation funds would be recognized rather than the benefit earned by employees during the year. Further, any payments to an employee pension or superannuation fund that should have been made during the period under an agreed funding plan but were not made, would not be recognized as an expenditure or liability. Only those amounts actually paid during the year would be reflected in the financial statements.

.084 A disadvantage to the cash basis in terms of completeness and reliability is that payments may be deferred at the end of the accounting period so that, in essence, the expenditure is not recognized until the following period even though an obligation exists.

.085 Even under the cash basis, however, separate schedules of borrowings are often prepared and published because of the importance of the government's level of debt for fiscal and monetary policy purposes. In Hong Kong, for example, even though the government’s accounts are kept on a cash basis, liabilities and contingent liabilities are included in the notes to the accounts.

.086 While the cash basis of accounting is often seen as an effective basis of accounting to demonstrate compliance with spending limits and with other legal and contractual requirements, its focus is primarily on the cash flows that took place during the year. It ignores not only liabilities arising out of normal operations, but also debt and other long term liabilities. So, financial statements prepared on this basis do not provide vital information needed to evaluate the government's or unit's ability to finance its activities and to meet its liabilities and commitments.

Figure 4.2

LIABILITIES REPORTED UNDER DIFFERENT BASES OF ACCOUNTING

CASH*	MODIFIED CASH	MODIFIED ACCRUAL	ACCRUAL
	Accounts payable within a specified number of days**	Accounts payable	Accounts payable
	Transfer payments payable within a specified number of days**	Transfer payments payable	Transfer payments payable
	Borrowings**	Borrowings	Borrowings
		Accrued liabilities*** (e.g., employee pension obligations and accrued interest)	Accrued liabilities*** (e.g., employee pension obligations and accrued interest)

***** Under the pure cash basis, liabilities are not recognized in the financial statements. However, separate schedules of borrowings are frequently prepared and published.

****** The specified number of days will be extended as the basis of accounting moves from the modified cash towards the modified accrual and full accrual bases. Borrowings may be reported under some forms of modified cash accounting (usually in the form of a separate schedule).

******* The concept of a liability under some forms of modified accrual and some forms of full accrual accounting will be the same or similar.

Modified Cash Basis

.087 Under a modified cash basis, payments in a defined period after year-end related to goods and services acquired in the previous year are either recognized as payables, or may just be put through as an expenditure of the previous year. Liabilities that are recognized can reasonably be expected to be paid shortly after the reporting period. As such, they are usually related to accounts payable or transfer payments payable within a specified number of days.

.088 While there is no attempt to identify or quantify any other long term obligations, such as employee pension obligations, borrowings may be reported under some forms of modified cash accounting (usually in the form of a separate schedule).

.089 Study 1 observes that *"simple modifications of the cash basis meet the same objectives, to the same extent, as* *the cash basis itself. The focus is on the flow of current financial resources, however, and there may be less room for manipulation."*

Modified Accrual and Full Accrual Bases

.090 Under both the modified accrual and the full accrual bases, most if not all liabilities would be recognized. Liabilities are recognized for all goods and services acquired during the year, including deferred compensation and accruing employee benefits, such as employee pensions/superannuation and vested sick leave or vacation pay. In addition, all borrowings and debt would be recognized, as would transfer payments due even where no value is received directly in return. Therefore, the financial statements would report accounts payable, accrued liabilities, transfer payments payable, debt and other borrowings.

.091 There is not a clear distinction between liabilities that would be reported under the expenditure basis and those reported under the full accrual basis. There may, however, be arguments on the definition of, or criteria for identifying, liabilities. For example, at the far end of the spectrum, questions arise as to which obligations meet the definition of a liability and should be quantified.

.092 Such debate continues for business enterprises too — it is really only since the 1960's that there has been recognition of liabilities arising from employee pension obligations. The debate carries on today with respect to other post employment benefits.

.093 It is at this end of the spectrum that the line between commitments, contingencies and liabilities becomes unclear as there may be a desire to reflect, as liabilities, obligations and commitments that may pose a potential draw on the government's resources.

.094 In addition, as one attempts to capture liabilities that will be settled further into the future, measurement difficulties arise. Many liabilities have to be estimated. The fact that amounts to be paid involve an estimate would not be sufficient reason to defer recognition of the liability, under the modified accrual or full accrual bases. An imprecise estimate of a large liability is preferable to ignoring the existence of the liability.

.095 As the IASC Framework observes, *"in many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability"*. The amount must be measurable, but that would allow for a reasonable estimate and does not require certainty.

.096 The measurement of some liabilities, such as those arising from pension or superannuation schemes, will involve a number of assumptions. The measurement basis may take that inherent imprecision into account. The method of calculating the pension liability may, for example, amortize changes arising from experience gains and losses or due to changes in the underlying assumptions for that very reason. In addition, the notes to the financial statements can also provide information about the extent of measurement uncertainty, including underlying assumptions and the sensitivity of the estimate.

.097 In making the transition from a cash-based system to an accrual system, governments may find it useful, or necessary, to take a step by step approach. There may be concerns that the requirement to identify and measure liabilities will unduly delay financial reporting. Indeed, systems that capture the information need to de developed and trade-offs between relevance and timing will undoubtedly occur.

.098 Thus, the introduction of accounting for liabilities may need to be phased in over time in order to give governments sufficient time to acquire the necessary accounting systems, resources and expertise. For example, it may be useful to begin by capturing those liabilities that can be identified because payments are made for them in a defined period after year-end. Once adequate systems are in place for those liabilities, governments can then begin to identify longer-term liabilities and reliable ways to measure them.

.099 It may also be useful to experiment with reporting before trying to develop an integrated financial statement. For example, South Africa developed and published a Statement of Liabilities that reports on the government's liabilities, commitments and contingent liabilities. While it is not yet audited, the statement explains the intention to do so once the necessary accounting and other systems are implemented and refined. Similar experimental reporting has been common in Australian jurisdictions as a precursor to full accrual reporting of liabilities in audited financial statements.

Current practice

.100 Appendix 1 summarizes the types of liabilities that are currently being recognized by governments.

.101 At the summary financial statement level for national governments, practice varies significantly. Those national governments that do not prepare summary financial statements but rather report on separate appropriation accounts, generally, do not record liabilities. However, in some countries, there is a more complete reporting at the departmental level and it is in those financial statements that the government's liabilities are recorded.

.102 Most governments do record accounts payable arising from the purchases of goods and services and transfer payments payable (at least to the extent that they have been included in the approved budget). Significant liabilities that are often not reported by governments include employee pension or superannuation entitlements (which may be being funded on a "pay-as-you-go" basis with accounting recognition matching the funding pattern), and other deferred employee benefits or compensation. In some cases, liabilities that are not recorded in the financial statements themselves are disclosed in the notes to those financial statements.

.103 With the exception of New Zealand, no other countries report currency issued as a liability. This would most likely be due to the fact that the Central Bank function is not considered to be part of the government reporting entity in many countries.

Why governments should recognize liabilities

.104 Reporting liabilities is important for both accountability and decision making. In addition to the cost of future services, governments have to meet past debts as they come due. Governments must be able to realistically estimate whether they can continue to afford the quality and quantity of services they now deliver, or whether they can afford new programs and services. Governments, as well as analysts and other users of government financial reports, cannot make sound decisions on those matters without an understanding of the full nature and extent of the government's liabilities.

.105 It's not enough to focus on the government's outstanding debt. Other liabilities represent equally valid claims on government resources. Ignoring growing liabilities related to employee pension or superannuation obligations, for example, may simply hide a growing financing problem. Consider, for example, a government that has previously funded its employee pension or superannuation plan on a pay-as-you-go basis and has not reported the actuarial unfunded liability. If that government decided to fund its actuarial pension liability today and invest the funds in the government's own debt, all of a sudden a previously unrecorded liability would become debt. Yet nothing, in substance, has changed.

.106 Many countries are becoming keenly aware of the dangers of escalating debts. One of the great barriers to sound decision making is incomplete and fragmented financial information that fails to show all that government owes.

.107 Further, when liabilities go unreported, it becomes more and more difficult to change the financial reporting systems so that they can be reported. Most governments do not like the political impacts of uncovering previously "hidden" liabilities. Many of the unreported liabilities, such as employee pension obligations, are large and, in some cases, can significantly impact the government's reported financial position. On the other hand, a change in government has been used as an opportune time to book previously unrecorded liabilities because doing so demonstrates the "openness" of the new government by "cleaning up the books".

.108 The simple fact is that if the liabilities are not reported, they cannot be taken into account when making decisions, and governments cannot exercise the stewardship assigned to them in respect of liabilities.

.109 It should be noted that debt and other liabilities, in and of themsleves, should not be construed as reflecting negatively on the government. Rather it is the government’s ability to meet its obligations when they come due and the impact of the level of indebtedness on fiscal flexibility that is important. In order to make these sorts of assessments of the government’s financial condition, it is necessary to put the government’s financial position into a broader economic context. Thus, governments may want to also report certain key ratios, such as the debt as a percentage of gross national income, or debt interest to revenues.

CHAPTER 5

REPORTING CONTINGENCIES AND COMMITMENTS

.110 There are a number of items that do not meet the definition of a liability but which may, at a future date, become liabilities. Most of these fall into the categories of contingencies or commitments.

IASC Standards for Contingencies

.111 International Accounting Standard 10, *Contingencies and Events Occurring After the Balance Sheet Date*, says that the accounting treatment of a contingent loss is determined by the expected outcome of the contingency. It recommends that a contingent loss should be accrued if:

(a) it is probable that future events will confirm that, after taking into account any related probability of recovery, an asset has been impaired or a liability incurred at the balance sheet date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

.112 IAS 10 also requires disclosure of the existence of a contingent loss in the notes to the financial statements if either of the conditions cannot be met, unless the probability of loss is remote.

.113 There may be a range of amounts of loss which could result from the contingency. In this case, the best estimate would be accrued. When no amount within the range is a better estimate than any other amount, at least the minimum amount in the range would be accrued. Exposure to loss in addition to the amount accrued would be disclosed.

.114 IAS 10 also notes that the existence and amounts of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise would generally be disclosed in the financial statements even though the risk of loss is remote.

.115 Under IAS 10, contingent gains are not accrued in the financial statements, although their existence would be disclosed if it is probable that the gain will be realized.

Current practice

.116 Governments may have contingencies arising from, for example:

- insurance payments due for losses resulting from bank failures, crop failures, floods, expropriations, loss of life and other unplanned events;
- indemnity agreements;
- loan guarantees;
- performance guarantees, such as those guaranteeing certain levels of revenue or profit in a joint venture with a private sector organization; and
- claims and pending or threatened litigation.

.117 Appendix 1 pages v-vii and Figure 5.1 show that practice is mixed as to not only whether governments recognize provisions for estimated losses related to contingencies but also whether their exposure to contingent losses is even disclosed.

.118 Some governments record provisions when the loss is probable and measurable, which is consistent with IAS 10. Other governments, however, report the loss only when realized. Italy sets up a reserve for contingent losses and there are strict rules as to when funds from the special reserve can be used to cover unexpected contingencies. (Note that other governments may have similar reserves, but they may not be displayed separately in the summary financial statements.)

Why governments should disclose their contingencies

.119 Most governments will be exposed to some contingent losses. For example, governments may use loan guarantees as a significant tool for providing financial assistance; they may be exposed to settlements under legal claims; or they may offer insurance type programs to cover losses arising from bank failures or crop failures (at least to a certain level). In substance, these contingencies are no different than the types of contingencies that business enterprises face.

.120 In assessing the financial condition of a government, it is important to understand the government's risk and exposure to loss. At a minimum then, governments should disclose their exposure to loss related to any contingencies. To fully appreciate the risk and exposure to loss, it would be useful for readers to disclose the full exposure of loss as well as some indication of the probable or most likely loss. Such disclosure could be by way of notes to the financial statements which describe the government's significant contingencies, and/or in a schedule (as is presented in the Financial Statements of the Government of New Zealand).

.121 Perhaps the more complex issue is whether governments should recognize a provision for likely or probable losses related to a contingent loss. Some people argue that such provisions do not meet the definition of a liability because there is no present obligation until the occurrence of a future event. They would argue, therefore, that such provisions shouldn't be included on the statement of financial position with liabilities.

.122 To a certain extent, this may be a debate centred more on terminology rather than substance. For example, they may view a contingent liability as an item that meets the definition of a liability but does not meet the criteria for recognition. Therefore, once it is probable that future economic benefits or service potential will flow from the entity, and the loss can be reliably measured, they would argue that the item is no longer a contingent liability but meets the definition of a liability. The loss would still be reported, but not as a provision for the contingent liability.

.123 Those countries that do recognize provisions for likely losses arising from contingencies generally do include them with their liabilities. Whatever the treatment, it should be clear in the accounting policies accompanying the financial statements.

.124 The same arguments can be made for recognizing provisions for likely or probable losses related to contingencies as is made for recognizing all of a government's liabilities — it provides a better basis for assessing the claims on the government's existing resources. However, doing so requires considerable judgment in estimating not only if a loss is likely to be incurred in the future, but also the amount of the loss. It adds even more uncertainty to the measurement of an amount reported on the financial statements. Nevertheless, the relevance of such information to the accounting and decision making needs of users arguably outweighs the inherent uncertainty.

Figure 5.1

COMPARISON OF DISCLOSURE REQUIREMENTS FOR CONTINGENCIES

COUNTRY	**DISCLOSURE**
Australia	Contingent liabilities are required to be disclosed by way of note. “This Standard requires the disclosure of the nature and, where they can be measured reliably, the amounts of such liabilities. Disclosure of this information assists users in assessing the performance and the present and expected financial position of a government.” *(Proposed Australian Accounting Standard, Financial Reporting by Governments, ¶.93 and .94, ED 62, March 1995)*
Canada	Financial statements should disclose information to describe a government's material contingencies at the end of the accounting period. ...Such information helps users assess the financial resources that may be required or available. *(Public Sector Accounting and Auditing Handbook, Section 1500 ¶ .60 - .61, 1986)* A provision for losses on loan guarantees should be established when it is determined that a loss is likely, and should be accounted for as a liability and expenditure. *(Public Sector Accounting and Auditing Handbook, Section 3310, ¶ .08, 1995)*
Italy	To be able to meet unforeseen and unexpected contingencies a special reserve fund is provided, by law. This reserve is included in the current section of the budget of the Ministry of Treasury and covers incidental charges or possible lack of allocation of the budget or other expenditures not expressly indicated in the budget law. In any case, the special reserve fund covers expenditures that don't have character of continuity. All transfers of amounts to this reserve fund and their allocation in the budget sections can give rise to a law-decree of the president of the Republic under the proposal of the Treasury and have to be approved by the General Audit Institution. The details of all such transfers to and from these reserve funds are included in the State's general financial statement.
Netherlands	In the state balance sheet provisions are not made. In the explanatory notes nothing is mentioned about unforeseen circumstances and or conditional events. These "losses" are taken when the respective expenditures occur. The coming Accounts Act for provincial and local governments states that the financial accounts (including the balance sheet) are adopted, taking into account all events and circumstances between balance sheet's day and adopting day, that are relevant to the necessary insight. Provinces and local governments can record a provision if necessary in the balance sheet.

Figure 5.1 cont'd

COMPARISON OF DISCLOSURE REQUIREMENTS FOR CONTINGENCIES

COUNTRY	**DISCLOSURE**
New Zealand	Contingent liabilities are disclosed in the government's financial statements. Contingent assets are not. The statement of Contingent Liabilities lists both quantifiable and nonquantifiable contingent liabilities. They are disclosed separately and are organized under various headings. Contingent liabilities of combined sub-entities (i.e., those that are line-by-line or equity accounted) to external parties are included. Contingencies within the group reporting entity are not relevant to report in the combined financial statements and are not included.
Taiwan	Contingencies are generally disclosed in notes or supplemental schedules. Those contingencies that can be reasonably estimated and are of high probability of occurrence should be recorded in the financial statements.
United Kingdom	Appropriation accounts, being drawn up on a cash basis, do not recognize contingencies. In accruals-based accounts, contingencies are dealt with in accordance with the requirements of SSAP 18, i.e., material contingent losses should be accrued where it is probable that a future event will confirm a loss which can be estimated with reasonable accuracy at the date on which the financial statements are approved by the directors (not the balance sheet date). The existence of a contingent loss may be disclosed by way of note if it is not appropriate to accrue it. Contingent gains should not be recognized.
United States	A liability is recognized for a contingent loss that is based on a past transaction or event and the amount of loss is probable and measurable. Disclosure is required if (1) any of the above conditions are not met and (2) there is at least a reasonable possibility that a loss may have been incurred. Disclosure includes the nature of the contingency and an estimate of the range of possible loss. *(Statement of Recommended Accounting Standards #4, "Accounting for Liabilities of the Federal Government", 1995)*

IASC Standards for Commitments

.125 As mentioned in Chapter 2, the IASC has not formally defined a commitment. IAS 5, *Information to be Disclosed in Financial Statements*, however, does require business enterprises to disclose amounts committed for future capital expenditure.

.126 IAS 17, *Accounting for Leases*, is an example of a standard that expands on the general disclosure requirement in IAS 5. It requires the disclosure of commitments for minimum lease payments under finance leases and under non-cancellable operating leases with a term of more than one year in summary form, showing the amounts and periods in which the payments will become due.

.127 Disclosing commitments is also discussed in IAS standards on banks (for various types of commitments) and joint ventures (disclosing share of capital commitments).

Current practice

.128 Similar to business enterprises, governments may have commitments arising from the purchase of goods and services to be provided as set out in existing contracts, agreements or legislation. This would include commitments for lease agreements and physical asset acquisitions. As Appendix 1 page viii and Figure 5.2 show, those governments that do disclose information about their material commitments, usually restrict the disclosure to this type of commitment.

.129 New Zealand has one of the most complete disclosures of their commitments. They include a Statement of Commitments in their summary financial statements that identifies commitments by type, segregated according to capital and operating commitments, as well as by function.

.130 The United States prototype financial statements also disclose commitments. They disclose commitments by agency for long-term contracts such as leases and for undelivered orders. The notes also provide a description and two different calculations concerning the social security program, which is their largest social entitlement program. The United States also has issued for exposure a proposed standard on reporting stewardship information that requires additional information on social security and on amounts expected to be paid relating to all social insurance programs.

.131 Canada's summary financial statements identify seven categories: fixed assets, purchases, operating leases, transfer payment agreements, capital leases, international organizations and benefit plans for veterans.

.132 As discussed in Chapter 2, however, governments may also have commitments under legislation, such as entitlements under social programs. With the exception of the United States (as discussed in paragraph .130) governments generally do not disclose estimated commitments under these types of commitments in their general purpose financial statements.

Why governments should disclose their commitments

.133 Information about a government's commitments is useful information for users because it gives an appreciation of the extent to which the government's resources are already committed to meet certain obligations in the future. As such, the information is useful in understanding and assessing the government's future revenue requirements and, thereby, the constraints that already exist with respect to the government's future activities. Therefore, disclosure of information about commitments is as important as reporting all liabilities, as well as provisions for likely losses related to contingencies, and disclosing the government's risk and exposure to loss from all contingencies.

.134 The question becomes, which commitments? Clearly, governments can readily report the types of commitments that businesses report — those related to purchase of goods and services to be provided as set out in existing contracts, agreements or legislation. Like businesses, governments may also have some commitments that are, in substance, liabilities. An example would be a capital lease under which the government has assumed substantially all of the benefits and risks of ownership. Some governments do recognize the present value of future payments under such "commitments" as liabilities.

.135 An argument can be made that a government's entire budget, once approved, can be considered a government expenditure commitment. But disclosure of that "commitment" would be of little use in the government's financial statements.

.136 Should, however, information about commitments arising from ongoing social programs be disclosed? The question of social program accounting and disclosure has little or no equivalent in other profit or nonprofit entities. It can be argued, that under the full accrual basis of accounting, readers can appreciate the longer-term spending impact of the present level of activity. But changing demographics or other reasons may result in quite a different level of cost in the future.

.137 For example, a recession could substantially increase the number of citizens seeking both unemployment compensation or welfare assistance. For governments that offer some form of social health programs, the predicted level of health care expenditures may increase substantially on a per capita basis, even if the present standard of publicly supported health care is maintained, simply because the proportion of elderly in the population may increase in the next decades — which is predicted in a number of countries. For the same reason, national pension schemes may also face marked increase in expenditures.

.138 In the *Federal Government Reporting Study* undertaken jointly by the Office of the Auditor General of Canada and the United States General Accounting Office (FGRS Study), almost all users (which included legislative users, citizens, media, policy analysts, special interest groups, government planners and managers, economists, corporate users and lender, security dealers and their advisers) said that future-oriented information on social programs was useful. They said that such information was needed to assess future borrowing requirements and taxation levels and the resulting impact on the economy, the long-term viability of social programs; and policy options available to control or reduce spending or deficit levels.

.139 Certainly when governments are deciding on new programs, long-term forecasts of the costs of present programs are relevant information. It could be argued that the best way to force consideration of long-term effects on governments (whose attention may be on winning the next election, in a democracy) would be to require long-term projections in budgets and annual financial reports for costs of major programs. For example, the New Zealand Government is required by the Fiscal Responsibility Act 1994 to publish long term projections, economic and fiscal updates, and forecast financial statements for the New Zealand Government. It should be noted, however, that such information is included in the government's budget documents rather than in their general purpose financial statements.

.140 If it is accepted that such information would be useful, the next question is what should be disclosed and how should it be measured. Some measure of the projected spending levels would be required. Future-oriented information can take the form of an actuarial projection of future benefit payments and future contributions, or the actuarial liability represented by the summation of the present values of the streams of future benefit payments less contributions.

.141 Such projections are estimates that some would argue are so imprecise as to make them unreliable. At a minimum, it would be important to understand the assumptions used in making them. Those assumptions may be controversial (such as expected inflation rates, expected unemployment rates).

Figure 5.2

COMPARISON OF DISCLOSURE OF COMMITMENTS

COUNTRY	**DISCLOSURE**
Australia	Commitments are required to be disclosed by way of note. "The general financial report of a government shall disclose, by way of note, capital expenditure commitments which have not been recognized as liabilities in the statement of financial position." *(Proposed Australian Accounting Standard, Financial Reporting by Governments, ¶.96, ED 62, March 1995)*
Canada	Financial statements should disclose information to describe a government's material financial commitments at the end of the accounting period. ... Such information is useful for understanding and assessing future revenue requirements. *(Public Sector Accounting and Auditing Handbook, Section PS 1500 ¶ .56-.57, 1986)*
Italy	Commitments are referred to only in the current financial year, with some exceptions. Commitments can also be referred to: • capital expenditures shared by law over several years; • current expenditures which need commitments charged to the next financial year; • rent and continuous expenses. The Government Accountancy Office must confirm to the General Audit Institution that commitments are included within the allowed expenses.
Netherlands	Disclosed in the operating statements. *(Dutch Government Accounts Act)*
New Zealand	Commitments are disclosed in both the government's financial statements and in those of departments and other entities. Commitments disclosed include those operating and capital commitments arising from non-cancellable contractual or statutory obligations. Interest commitments on debts and commitments relating to employment contracts are not included. Commitments are disclosed by type, by functional classification and by term.
Taiwan	For ordinary government departments, the unpaid portion of executed contracts generally are accrued in the year the contracts are signed.
United Kingdom	Appropriation accounts do not recognize commitments. Accruals based accounts should recognize commitments in accordance with the requirements of the Companies Act and relevant accounting standards. These essentially require disclosure of: • future capital expenditures contracted for but not provided for, and amounts by the directors but not contracted for; • particulars of pension commitments, both provided for and not provided for; • details of any other financial commitments which have not been provided for; and • commitments relating to leasing transactions.
United States	Commitments are disclosed in the notes of the prototype consolidated financial statements (unaudited) and supplemental tables provide additional information.

.142 Another alternative is to disclose information only about those commitments that are abnormal in relation to the government’s financial position or normal course of “business”, or that will have a significant effect on the need for revenue in the future. Businesses, for example, do not disclose information about employment agreements because they are in the normal course of business. Similarly, it could be argued that ongoing social programs are in the normal course of the government’s business and need not be highlighted unless there is a new program commitment or a significant change to expand existing programs.

.143 Assuming that reasonable estimates can be made, where they should be disclosed is also debatable. Do they belong in the "traditional" set of financial statements? While it would be ideal to include all information relevant to assessing a government's financial condition in a summary set of financial statements, that goal is unrealistic. Information about the costs of social programs is useful, but perhaps it is expecting too much from financial statements to meaningfully disclose that information in them.

.144 Indeed, some have pointed out that governments can and do change laws that entitle individuals to transfer payments. They do so based on their perception of tax revenue and other resources that will be available to make such payments. Therefore, if such obligations are to be reported in financial statements, the projected future taxes should, arguably, also be reported. Such reporting may more appropriately be a budget and planning function than a function of general-purpose financial statements.

.145 An alternative for describing a government's financial condition was proposed by the US Office of Management and Budget (OMB) in an appendix to its January 1993 budgetary statement: Budget Baselines, Historical Data, and Alternatives for the Future. The OMB argued that a conventional balance sheet could not accurately reflect all of the government's obligations nor all of its resources. It proposes a presentation in three separate tables that together would provide an overall view of the government's financial condition.

.146 The first table would include government assets (including both financial assets and physical assets) and financial liabilities; the second would show the government's resources and responsibilities in terms of budget projections of both receipts and of outlays on such items as social security and medical programs; and the third table could show national wealth and well-being in terms of national assets/resources (including both federally owned physical assets and their contribution to assets held by others) and national needs/conditions in terms of economic, social, educational and environmental well-being.

.147 There is no doubt that some sort of information on commitments arising from social programs is useful information, and even necessary information to fully evaluate the financial condition of the government. In fact, government financial reporting may provide much greater emphasis on publicly reporting claims on future resources than private sector organizations because of the government’s responsibility for the general welfare of the country and its resulting willingness to take on obligations. The inherent problems in providing such information is probably the reason that virtually no governments are now including that sort of information in their summary financial statements. So, while it is useful information, it is an area that requires further study.

CHAPTER 6

CONCLUSIONS

.148 Study 1 concluded that users of government financial reports need information to assess the government's overall financial condition, to predict the timing and volume of cash flows and future cash and borrowing requirements and to assess the governments ability to meet its financial obligations, both short and long term[1].

.149 To be able to meet those needs, governments need to report information about their liabilities and about their risk and exposure to losses and potential obligations related to contingencies and commitments. Such information is vital to both effective decision-making and accountability.

.150 Yet many government financial statements do not now include this information. While most governments report, in some manner, their outstanding debt, other liabilities are ignored. Governments that have moved beyond the cash or modified cash basis of accounting and include liabilities and, in some cases, provisions for losses related to contingencies, sometimes express concern that doing so may put them at a disadvantage in the financial markets. There is no clear evidence that this is the case.

.151 Without full and complete information about their liabilities, contingencies and commitments, governments and other users of government financial reports cannot make realistic assessments about the government's financial condition as a basis for making sound decisions about the quality and quantity of services they provide. The risk of making poor decisions is much greater if legislators, government managers, and their advisers have incomplete and fragmented information that fails to show all that a government owes.

.152 To meet these information needs, governments must at least move along the spectrum in the bases of accounting to a modified accrual basis.

.153 Doing so will give rise to some complex measurement issues related to some government obligations. In many cases, those issues cannot be readily resolved by referring to practice and standards used by business enterprises and will require future study. Future study and debate is also needed to resolve issues related to obligations related to social programs, including not only how to measure those obligations but where and how information about them should be reported.

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[1] IFAC Public Sector Committee Study 1, *Financial Reporting by National Governments*, paragraphs .048, .050 and .052.

APPENDIX 2

Glossary of terms

Basis of Accounting: refers to the body of accounting principles that determine *when* the effects of transactions or events should be recognized for financial reporting purposes. It relates to the timing of the measurements made, regardless of the nature of the measurement. Common bases of accounting are the cash basis of accounting (i.e., effects of transactions or events are recognized when cash is paid or received) and the accrual basis of accounting (i.e., effects of transactions and events are recognized when they take place). There are many variations of both bases.

Elements of Financial Statements: refers to the types or classes of items that are reported in the financial statements, including notes thereto and related schedules. That is, the classes of items around which the financial statements are constructed.

Financial Reporting: refers to the communication of financial information by an entity to interested parties. It encompasses all reports that contain financial information based on data generally found in the financial accounting and reporting system. It includes financial statements as well as financial information presented in budgets, fiscal plans and estimates of expenditure or reports on the performance of individual programs or activities.

Financial Reports: refers to the general purpose financial reports that are designed to meet the common information needs of users outside of the entity. Those external users rely on the reports as an important source of financial information because they have limited authority, ability, or resources to obtain additional information. While financial statements comprise the core of the financial reports, other financial information, such as performance measures and budget information, might also be included.

Financial Statements: refers to the accounting statements prepared by a reporting entity to communicate information about its financial performance and position. They include those notes and schedules that are needed to clarify or further explain items in the statements. For business-oriented enterprises, financial statements normally include a balance sheet, income statement, statement of retained earnings and statement of cash flows. Governments and governmental units may have a similar set of statements or may have lists of assets and liabilities, revenues and expenditures. The statements similar to the balance sheet and income statement are commonly referred to as statement of financial position and statement of financial performance in the public sector.

Measurement Focus: refers to *what* messages and information are portrayed in the financial statements. A particular measurement focus is accomplished by considering not only when the effects of transactions and events involving those resources are recognized (i.e., the basis of accounting), but also what resources are measured. For example, the financial statements of business enterprises are designed to measure profit or loss and changes in shareholders' equity. Government financial statements could be designed to express, for example, the flow of economic resources, the flow of total financial resources or the flow of current financial resources.

Reporting Model: refers to the configuration and presentation of financial statements, in particular, what statements are included in the set of financial statements, how they interrelate, and how key measures are displayed in them.

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