TREASURER'S DIRECTIONS

ACCOUNTING – Liabilities

Section A3.7 : Contingent Liabilities

STATEMENT OF INTENT

Contingent liabilities have the potential to expose the Territory to financial obligations which are not otherwise recognised in financial statements. This section provides a framework for the identification, management and disclosure of Contingent Liabilities of the Territory. Agencies are to implement appropriate controls to mitigate risk exposure of the Territory arising from contingent liabilities.

MAIN FEATURES

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

Contingent Liabilities

- Contingent liabilities are: (a) possible obligations arising from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events, or (b) present obligations arising from past events that have failed the criteria for recognition as liabilities or provisions.

Risk Management

- Each contingent liability is to be reviewed regularly and the details of the contingent liability revised, where necessary, to reflect the nature, description and associated risks.
- An Agency is to establish appropriate risk management strategies to ensure the Agency's and the Territory's exposure to risk arising out of contingent liabilities is contained and minimised.
- Each Agency is to advise Northern Territory Treasury of any changes to the risk profile of contingent liabilities that could materially affect the Territory's financial projections for a budget year.

Register of Contingent Liabilities

- An Agency is to maintain a register of all contingent liabilities, including those resulting from guarantees and indemnities approved by the Treasurer or a delegate.

Disclosure of Contingent Liabilities

- Material contingent liabilities of the Territory, including entities controlled by the Territory, are to be disclosed in the Treasurer's Annual Financial Report.
- Material contingent liabilities (other than contingent liabilities associated with litigation) within the responsibility of an Agency are to be disclosed by the Agency in the notes to its Financial Statements.

Audit Requirements

- The Auditor-General will conduct periodic audits of agencies' internal procedures for reviewing and managing contingent liabilities.
- Information provided by agencies may be subject to audit in the preparation of the Treasurer's Annual Financial Report.

For authoritative instruction and guidance reference should be made to related Treasurer's Directions and associated commentary, relevant Australian accounting standards, and other authoritative interpretations.

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CONTENTS

AUTHORITIES

Section 11 and 34 *Financial Management Act*

Sections 10 and 22 *Fiscal Integrity and Transparency Act*

REFERENCES

AASB 101	Presentation of Financial Statements
AASB 137	Provisions, Contingent Liabilities and Contingent Assets
AASB 139	Financial Instruments: Recognition and Measurement.

Related Treasurer's Directions

A3.1	Accounting – Liabilities: Overview
A3.3	Accounting – Provisions
G2.5	Governance – Accountability: Guarantees and Indemnities

WHAT ARE CONTINGENT LIABILITIES?

A3.7.1

> Contingent liabilities are :
>
> (a) possible obligations that arise from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Territory; or
>
> (b) present obligations that arise from past events but are not recognised as liabilities or provisions because:
>
> - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligations; or
> - the amount of the obligations cannot be measured reliably.

(i) A contingent liability arises when a past event gives rise to a potential obligation. A current court case where the outcome is uncertain, but which may result in an obligation is an example.

(ii) The potential obligation has to be one enforceable by law or a valid expectation. There is no discretion on the part of the Territory whether to fulfil the obligation if the liability has crystallised.

(iii) A contingent liability can also be viewed as a present obligation which does not fully meet the definition of a liability or provision, and is therefore not recognised. A liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. A provision is a liability of uncertain timing or amount. For further guidance on liabilities and provisions refer to Appendix B: Liability Decision Tree within Treasurer's Directions A3.1 - Liabilities: Overview and Treasurer's Directions A3.3 - Provisions.

(iv) A contractual arrangement whereby a clause of the contract grants an indemnity (the present obligation) by the Territory is an example of such a contingent liability.

(v) Exposure to risk does not in itself give rise to a contingent liability. There must be a past transaction or event that raises the possibility of a liability. For example, a tax audit alone would not constitute a contingent liability, but an audit finding with potential adverse financial consequences on the Agency could give rise to a contingent liability.

(vi) Similarly, an intention to make a future sacrifice of economic benefit (eg capital works program commitment or a budget) does not give rise to a contingent liability. Both contingent liabilities and commitments are possible obligations that will be confirmed by the occurrence or non-occurrence of one or more uncertain future events. The difference between the two arises from the nature of the future event. A commitment is directed towards a desirable event or outcome, whereas a contingent liability accounts for the possibility of an undesirable event or outcome. By their nature, commitments are more likely to be crystallised than contingent liabilities. For further guidance on commitments refer to Treasurer's Directions A3.1 - Liabilities: Overview.

(vii) If an event occurs which triggers or crystallises a liability or provision, the contingent liability is replaced with a reportable liability or provision in the statement of financial position. A court case, first considered in (i) above, will result in a provision if there have been developments in the case making it probable that the entity will be found liable. The provision will be the best estimate of the amount required to settle the obligation. If the case has been decided and the entity has been found liable, then a liability equal to the amount required to settle the obligation will be reported.

A3.7.2 **A guarantee or indemnity granted by the Territory or an Agency that is a separate legal entity will result in a contingent liability of the Territory or the Agency.**

(i) Guarantees and Indemnities are generally contained in instruments (eg an agreement, contract or a deed) where the Territory or Agency agrees to assume the financial obligations of another party (refer Treasurer's Direction G2.5).

(ii) Guarantees or Indemnities contained in instruments continue to be recognised as contingent liabilities of the Territory or the Agency until the sooner of:

(a) an event which triggers a liability or provision occurs; or
(b) the limitation period for the indemnity expires.

(iii) The limitation period for an indemnity is a period, specified by the *Limitations Act*, from the date the cause of action that gives rise to the right to claim under the indemnity first occurs. Consequently, while the agreement giving rise to the indemnity has expired, the indemnity may still be current.

(iv) Agencies need to be aware that a guarantee which meets the definition of a financial guarantee contract needs to be recognised as a financial liability in the books of an Agency. A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. Further guidance and instructions on financial guarantees is found in *AASB 139 Financial Instruments: Recognition and Measurement*.

RISK MANAGEMENT

A3.7.3 **An Agency is to review contingent liabilities for which it has responsibility, at a minimum annually, and the Agency's records updated, where necessary, to reflect the current assessment of likelihood and consequence of a reportable provision or liability arising.**

(i) Over time the circumstances associated with contingent liabilities change. An Agency is required to review all contingent liabilities for which it has responsibility on a regular (at least annual) basis as part of Agency risk management processes.

(ii) Depending on the assessed likelihood and consequence of crystallisation of a reportable liability, different contingent liabilities may be reviewed at different time intervals. Contingent liabilities with minor risks or which would result in limited financial exposure could be reviewed less frequently (eg annually), while those which are more risky or have potentially more significant financial exposure should be assessed more frequently (eg quarterly).

A3.7.4 **An Agency is to have appropriate risk management strategies in place to ensure that the Agency's and the Territory's exposure to contingent liabilities is contained and minimised.**

A3.7.5 **These risk management strategies are to be reviewed periodically to ensure continued appropriateness.**

(i) The likelihood of a real liability arising from a contingent liability can be minimised by an Agency taking appropriate steps to understand, manage and mitigate the associated risks. The approach adopted will vary depending on the type of risk involved and can include simple measures such as staff training and education, to the establishment of more complicated risk management framework involving a continual process of risk identification, evaluation and control.

(ii) The nature and level of sophistication involved in risk management strategies will have cost implications and therefore the cost involved in risk management needs to be balanced against the likelihood and potential financial impact of the contingent liability being crystallised.

(iii) Risk management is a continuing process. An Agency is required to conduct periodic reviews of risk management strategies to ensure continued relevance and appropriateness.

A3.7.6	An Agency is to advise Treasury of any material changes to the risk profile of contingent liabilities that could affect the Government's financial projections for a budget year as and when the changes occur.
A3.7.7	This advice is to include an analysis of the likelihood and consequence of the budget impact.

(i) Under section 10(1)(e) of the *Fiscal Integrity and Transparency Act,* fiscal outlook reports prepared by the Territory are to include a statement of risks that could materially affect the financial projections for a budget year. These risks include those which arise as a result of contingent liabilities.

(ii) To satisfy this requirement, agencies are to advise Treasury of significant changes to material contingent liabilities, including any changes in the risks associated with those liabilities when the Agency becomes aware of the changes, or when requested by Treasury.

REGISTER OF CONTINGENT LIABILITIES

A3.7.8	An Agency is to maintain a register of all contingent liabilities, including those resulting from guarantees and indemnities approved by the Treasurer or a delegate.

(i) To enable efficient and effective risk management and mitigation, an Agency will be expected to maintain a register of all contingent liabilities. Refer to Treasurer's Direction G2.5 for the approval process for guarantees and indemnities.

(ii) Details to be included in the register of contingent liabilities are as outlined in <u>Appendix A</u>.

DISCLOSURE OF CONTINGENT LIABILITIES

A3.7.9	Material contingent liabilities of the Territory and entities controlled by the Territory are to be disclosed in the Treasurer's Annual Financial Report.
A3.7.10	Quantifiable contingent liabilities are to be reported at net present value based on an appropriate discount rate.

(i) All material contingent liabilities resulting from instruments entered into by the Territory or entities controlled by the Territory will be disclosed in the Treasurer's Annual Financial Report.

(ii) Material contingent liabilities can be quantifiable or non-quantifiable. For quantifiable contingent liabilities there exists a materiality threshold of $5 million in accordance with Treasurer's Direction G2.5: Guarantees and Indemnities.

(iii) The discount rate selected to compute net present value should equal the published government bond rate for bonds with a maturity period that aligns with the probable time to crystallisation of the contingent liability.

(iv) Material unquantifiable contingent liabilities are liabilities that could pose a risk to the Government's financial projections, eg health-related indemnities to specialist medical practitioners employed in public hospitals.

A3.7.11 **Material contingent liabilities within the responsibility of an Agency are to be disclosed by the Agency in the notes to its financial statements.**

(i) Material contingent liabilities are to be disclosed in an Agency's notes to its financial statements to provide a complete picture of the exposure and possible future financial obligations facing the Agency. The agency's contingent liability register should be used as a basis for this disclosure. Agency's disclosures in turn form the basis for Whole of Government reporting on contingent liabilities.

(ii) Disclosure includes the following for each class (where similar in nature) of contingent liability:

- brief description of the nature of the class of contingent liability;
- an estimate of the potential financial effect, or a statement that it is not possible to make such an estimate if that is the case;
- an indication of the uncertainties in terms of amount or timing of any outflow;
- an indication of the existence (if any) of any possible recovery against the contingent liability.

(iii) Legal proceedings or disputes in which the Territory or an Agency is a party are not separately disclosed. A general disclosure covering all litigation is made on the basis that the wide variety and nature of the individual cases and the uncertainty of any potential liability means that no value can be attributed to individual cases until such time as the courts make a decision. To attempt to attribute a value to a case also has the potential to prejudice the outcome of the proceeding or dispute.

(iv) In accordance with Section 11 of the *Financial Management Act*, Agencies should prepare a complete set of financial statements, including all notes, within two months of the end of the financial year, and forward a signed copy of the same to the Treasury for inclusion in the Treasurer's Annual Financial Report.

AUDIT REQUIREMENTS

A3.7.12 **The Auditor-General will conduct periodic audits of Agencies' internal procedures for reviewing and managing contingent liabilities.**

(i) The Auditor-General will undertake periodic agency compliance audits.

(ii) These compliance audits can be expected to include the following elements:

- audits of agency registers of contingent liabilities and compliance with disclosure and reporting requirements; and

- review of agency internal processes to ensure that all contingent liabilities are identified, included in the register and included as part of the notes to the accounts of the Agencies concerned (where required).

A3.7.13 **Information provided by agencies may be subject to audit in the preparation of the Treasurer's Annual Financial Report.**

APPENDIX A

An agency Register of Contingent Liabilities ensures that the agency maintains details of potential financial obligations resulting from indemnities approved by the Agency Minister, Accountable Officer or the Treasurer. Refer to Treasurer's Direction G2.5 for the approval process for indemnities and guarantees.

Details to be included in an agency Register of Contingent Liabilities include:

- A description of the contingent liability, including :

  a) name of the instrument;
  b) type of instrument (eg deed, grant, agreement);
  c) category in which the instrument falls (refer to TD G2.5 for categories with respect to guarantees and indemnities);
  d) position of delegate providing approval;
  e) date of delegate approval;
  f) date of execution;
  g) instrument expiry date;
  h) value of contingent liability;
  i) expiry date of contingent liability (refer to the *Limitations Act*)

- Risk assessment including likelihood of the contingent event occurring and the expected consequence if it occurs;

- Information on risk mitigation strategies adopted to manage risks associated with the contingent liability; and

- Details of discharge of the contingent liability, if applicable (date and manner).