GASAB

Indian Government Financial Reporting Standard (IGFRS) 5

Contingent Liabilities (other than guarantees) and Contingent Assets: Disclosure Requirements

Government Accounting Standards Advisory Board

About IGFRS

Government Accounting in India follows cash basis of accounting. Government Accounting Standards Advisory Board (GASAB) constituted by Comptroller and Auditor General of India, with the support of Government of India, has been working on migration to accrual basis accounting in Union and States. As per constitutional provisions, any change in basis of accounting (from cash to accrual) would essentially be based on a decision of President of India on the advice of Comptroller and Auditor General of India. However, there is a need felt for an accounting framework and accounting standards on accrual basis to facilitate pilot studies and research efforts on migration to accrual accounting at Union and State level. To facilitate such pilot studies and also for scale up of activities, GASAB decided to develop accrual basis accounting standards alongside cash basis standards. The accrual basis standards are issued under the title ***'Indian Government Financial Reporting Standards (IGFRS)'.*** These standards will initially be recommendatory for the pilot studies on accrual accounting and will become mandatory, with effect from the date of notification as such, by Government of India.

Bases for Conclusion (BC)

The IGFRS on Contingent Liabilities (other than guarantees) and Contingent Assets was first developed in February 2007. The purpose of the paper was to develop a standard to provide for disclosure requirements of Contingent Liabilities and Contingent Assets of the Government in the financial statements. It was considered as an important disclosure requirement to assess the risk of future liability government carries and possible assets that may arise to government.

BC 1 Under cash basis of accounting and financial reporting, generally cash receipts and cash payment and cash balances are reported. However, in view of the FRBM Act and Rules, a variety of information to be disclosed in the budget documents that are in the nature of contingent liabilities and contingent assets was required to be reported. Further, governments may disclose certain types of contractual obligations which are not present liability or may be under litigation where liability is uncertain. Certain possible assets such as revenue in arrears, which are under litigation, may also be disclosed. These are contingent because actual position of liability or asset will be confirmed only when related future events become certain. Disclosure of such information is relevant from the point of view of assessing possible future liability in case of contingent liability and future economic benefits and service potential in case of contingent assets.

BC 2 With the approval of GASAB during the 13th Board meeting, an exposure Draft on "Contingent Liabilities (other than guarantees) and Contingent Assets: Disclosure requirements" was developed. The Exposure Draft was presented for approval of the Board during the 17th Board meeting held on February 2009 for exposure and invitation to comments. The responses received from various stakeholders commented on the issue of materiality for disclosure, timing of disclosure, need for a separate statement of disclosure, trigger for recognition of contingent liabilities and assets and some illustrative examples.

BC 3 The FRBM Act 2003 mandates the Central Government to specify the annual target for assuming contingent liabilities in the form of guarantees. Accordingly, the FRBM Rules prescribe a cap of 0.5% of GDP in any financial year on the quantum of guarantees that the Central Government can assume in the particular financial year. In order to ensure greater transparency in its fiscal operation in public interest, the FRBM rules require the Central Government, at the time of presenting the annual financial statement and demand for grants, to make certain disclosure statements of receivables and payables in the Forms D1 to D3 detailed as under:

Form D1 – Tax Revenues raised but not realised

Form D2- Arrears of Non Tax Revenue

Form D3 – Guarantees given by the government

BC 4 Recently Government has notified IGAS 1 "Guarantees given by the Governments: Disclosure Requirements" to ensure uniform and complete disclosure of government guarantees. This disclosure does not make a distinction between guarantees and contingent liabilities. However, since contingent liabilities and assets both rests on the principle of payables and receivables respectively, the need for issuance of this Standard under accrual basis of accounting was considered.

Indian Government Financial Reporting Standard

Contingent Liabilities (other than Guarantees) and Contingent Assets: Disclosure Requirements

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Contingent Liabilities (other than guarantees) and Contingent Assets: Disclosure Requirements

The Standard, which is set in bold italic type, should be read in the context of the explanatory paragraphs in this Standard, which are in plain type. The Indian Government Financial Reporting Standards are not intended to apply to immaterial items.

Introduction

1. The purpose of the IGFRS on *Contingent Liabilities (other than guarantees) and Contingent Assets* is to provide for disclosure requirements of contingent liabilities (other than guarantees) and contingent assets of Governments in the financial statements. Disclosure of contingent liability is relevant from the point of view of knowing what risk of future liability the government carries. Disclosure of contingent assets is relevant in knowing what possible assets may accrue to government.

2. GASAB has already issued IGAS1 on guarantees. Other than guarantees (and letter of comfort) included in IGAS1, there are be other types of contingent liabilities. Fiscal Responsibility and Budget Management (FRBM) Acts and Rules framed there under require a variety of information to be disclosed in the budget documents that are in the nature of contingent liabilities and contingent assets. This standard aims at bringing in some of the Contingent Liabilities (other than guarantees) and Contingent Assets being disclosed in the financial statements for improved transparency.

3. Under cash basis of accounting and financial reporting, generally, cash receipts and cash payments and cash balance are reported. However, in some jurisdictions additional information on financial assets and financial liabilities may also be reported. Financial assets such as loans and advances and investments made by

governments and financial liabilities in the nature of long-term debt are reported. Further, governments may disclose certain types of contractual obligations such as guarantees, which are not present liability. Certain possible assets such as revenue in arrears, which are under litigation, may also be disclosed. These are contingent because actual position of liability or asset will be confirmed only when related future events become certain. Disclosure of such information is relevant from the point of view of assessing possible future liability in case of contingent liability and future economic benefits and service potential in case of contingent assets. Guarantees given and other such uncertain liabilities relate to contingent liability and revenue in arrears under litigation and other such uncertain assets relate to contingent assets.

Objective

4. The objective of the IGFRS on the subject is to lay down the principles for disclosure requirements of Contingent Liabilities (other than guarantees) and Continent Assets for both the Union and the State Governments including Union Territories with Legislatures, in their respective Financial Statements in order to ensure uniform and appropriate disclosure of such liabilities and assets. It also ensures consistency with international best practices leading to transparency and improved quality of disclosure in the financial reports of Governments for the benefit of various stakeholders. An important objective of the IGFRS is to ensure that Governments portray the risks associated with contingent liabilities and contingent assets in a transparent manner.

Scope

5. The IGFRS shall apply to both the Union and the State Governments including Union Territories with Legislatures in preparation of their financial reports. The IGFRS shall not include in its ambit guarantees (including letters of comfort) for which IGAS 1 would apply. The standard also excludes treatment of off budget borrowings, for which a separate statement may be developed, when found necessary.

Definitions

6. ***The following terms are used in this Statement with meaning specified, unless the context otherwise requires:***

i. ***Accounting Authority is the authority which prepares the Financial Statements of the Governments.***

ii. ***Accounting Period means the period covered by the Financial Statements.***

iii. ***Cash Basis of accounting is that wherein accounting transactions of an entity represent the actual cash receipts and disbursements during an accounting period as distinguished from the amount due to or by the entity during the same period.***[1]

iv. ***Consolidated Fund of India is the fund referred to in clause (1) Article 266 of the Constitution of India.***

v. ***Debt is the amount owed by Government for borrowed funds.***

vi. ***Financial Statements means the Annual Finance Statements of the Governments.***[2]

vii. ***Government means the Union Government or any State Government or Government of any Union Territory with Legislature.***

viii. ***Sector consists of a grouping of specific functions or services as per the 'List of Major and Minor Heads of Account of Union and States'.***

ix. ***Budget refers to the 'Annual Financial Statement' of the Union and State Governments in terms of the provisions of the Article 112 and 202 of the Constitution, respectively***

x. ***Accounts of the Union and the State Government refer to the annual and the periodical accounts as prepared by the accounting authority. They include the Monthly Civil Accounts, Finance Accounts, etc.***

[1] *Government Financial Rules*, 2005, Rule 68,*Government Accounting Rules*, 1990, Rule 21

[2] as distinct from budget document

xi. ***<u>Contingent liability</u>*** ***is: (a) 'a possible obligation that arises 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 entity; or (b) a present obligation that arises from past events but is not recognised because (i) it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.'***

xii. ***<u>Contingent asset</u>*** ***is 'a possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity'.***

Accounting for Contingent Liabilities and contingent assets

7. A contingent liability may arise due to either *legal obligation* or *constructive obligation*. A *legal obligation* relates to specific government obligation defined by law or contract, e.g., crop insurance, tax refunds under litigation, uncalled capital, indemnities, etc. A constructive obligation is an obligation that may arise when a government indicates to other parties that it accepts certain responsibilities and has created certain valid expectation on the part of those parties that it will discharge the responsibilities. Letter of comfort issued by governments (Union and States), expectation of bailing out public sector insurance, banking and other entities, etc. also represents a moral obligation or expected burden for the government not in the legal sense, but based on public expectations and political pressures.

8. Based on legal and constructive obligations, contingent liabilities can be grouped as :

   i. Explicit & Implicit Contingent Liabilities;

   ii. Funded and Unfunded Contingent Liabilities;

   iii. Quantifiable & Unquantifiable Contingent Liabilities.

Types of Contingent Liabilities	Items / examples
Explicit	a. Guarantees (not covered in this standard), b. Indemnities/ compensations, c. All litigations d. Litigation by pensioners for claim of revised pension due to law change e. State insurance payments due for crop failures, etc., f. Uncalled capital etc., (callable capital subscription to international body or bank, e.g., ADB etc.),
Implicit	a. Letter of comfort (not covered in this standard), b. Default of public sector entities on non-guaranteed debt, c. Liability clean up in entities being privatized/ liability arising out of privatization; etc.,
Funded	a. Guarantees (when Guarantee fee, Guarantee Redemption/ Reserve Fund is matched with possible liability)
Unfunded	a. Liabilities arising from legislated commitments as mentioned in Paragraph b. Liability arising from a change in legislation with retrospective effect c. Payments arising from termination of contractual agreements/ indemnity payments to compensate etc., d. Environmental liabilities (e.g., Bhopal tragedy where some relief expenditure incurred by Governments)
Quantifiable	Many of the contingent liabilities like guarantees, letter of comfort, tax refund litigations etc., would be quantifiable
Unquantifiable	Many of the contingent liabilities arising from liability clean up in entity being privatized, liability arising from legislated commitments would not be quantifiable

9. For the purpose of clarity and to distinguish contingent liability from liability, the two can be differentiated as follows:

	Liability	Contingent Liability
Obligation	Present / certain	Present/ possible
Timing	Certain	Uncertain
Amount	Certain	Uncertain and a reliable estimate can not be made
Outflow of resources	Certain	No probability/ probability depending upon occurrence / non-occurrence of certain other events in future
Recognition	Recognised	Not recognised but disclosed

10. **Under accrual basis of accounting, A contingent liability which is a possible obligation and not a present obligation (of nature (a) in definition of Contingent Liabilities) is not recognized but disclosed in the financial statements.**

11. **Under cash basis of accounting, provision will not be created and recognised even if there is a present obligation that probably requires an outflow of resources in future.**

12. Under cash basis of accounting and reporting, liabilities, e.g., current liability such as accrued liability and bills payable may not be recognised. As such, even when a present obligation has taken place and timing of payment is certain as well as the amount to be paid is reliably measurable, no liability is recognised and no provision is made until cash payment is actually made. It recognises only that current portion of cash flow, which goes towards liquidating the liability. However, disclosure of contingent liability is required to be made under accrual basis of accounting and its disclosure would help in tracking possible future obligations.

13. **C**ontingent liabilities are liabilities of uncertain timing or uncertain amount or both and hence are not recognised even under accrual basis of accounting but disclosed in the Financial Statements. Direct liabilities are predictable obligations that will arise in any event. Contingent liabilities are obligations triggered by uncertain event, timing, amount or all of them.

14. Given the wide range of involvement of Governments and the variety of possible liabilities, they are exposed to some or the other kind of contingent liabilities. To appreciate their total financial commitment and also risk and exposure to loss along with their financial impact on the exchequer, the Governments should disclose their contingent liabilities. More so, this is needed not only to maintain inter-generational equity but also to assess future sustainability. **Assessment of risk** involved in contingent liabilities periodically may help make suitable decisions with respect to fiscal sustainability.

15. **Contingent Assets are not recognized but disclosed in financial statements as they are dependent on uncertain future events and actual cash flow does not take place.**

16. Ownership of contingent asset is uncertain. It is only when certain events in future will take place that give rise to possibility of an inflow of economic benefits or service potential to an entity. Thus, inflow/ outcome is not certain and depends upon occurrence and non-occurrence of certain future events. For example, tax arrears, which are under litigation, may flow to government or may not flow depending upon the final verdict. Similarly, ownership of land acquired but under litigation may come to government or it may not. As such, these are contingent assets. However, disclosure of contingent assets is not restricted due to cash basis of accounting.

17. Contingent assets may arise due to legal or sovereign claim of government going under litigation. For example, tax demands raised but has been contested by the party involved in the court of law or designated tribunal may not be shown as tax arrears receivable but only contingent assets. Similarly, tax demands appearing difficult to be recovered due to assesses not traceable, companies having gone under either BIFR or liquidation, cases having gone to Settlement Commission, etc. may be disclosed only as contingent assets until declared irrecoverable.

Disclosure Requirements

18. **Disclosure requirements of guarantees and letter of comfort given by Governments have been mandated in IGAS1: *Guarantees given by Governments: Disclosure Requirements*.**

19. **Contingent liabilities (i) where there is a present obligation that probably requires an outflow of resources or (ii) where there is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources needs to be disclosed in the financial statements as a footnote or a separate statement listing the contingent liabilities.**

20. **Contingent Assets needs to be disclosed in the financial statements as a footnote or a separate statement listing the contingent assets.**

21. Government may disclose for each class of contingent liability at the reporting date:

    (a) a brief description of the nature of the contingent liability,

    (b) amount of financial effect or an estimate of its financial effect,

    (c) an indication of the uncertainties relating to the amount or timing of any outflow, and

    (d) the possibility of any reimbursement.

22. In case of contingent asset, Government may disclose:

    (a) a brief description of the nature of the contingent asset,

    (b) amount of financial effect or an estimate of its financial effect,

    (c) an indication of the uncertainties relating to the amount or timing of any inflow.

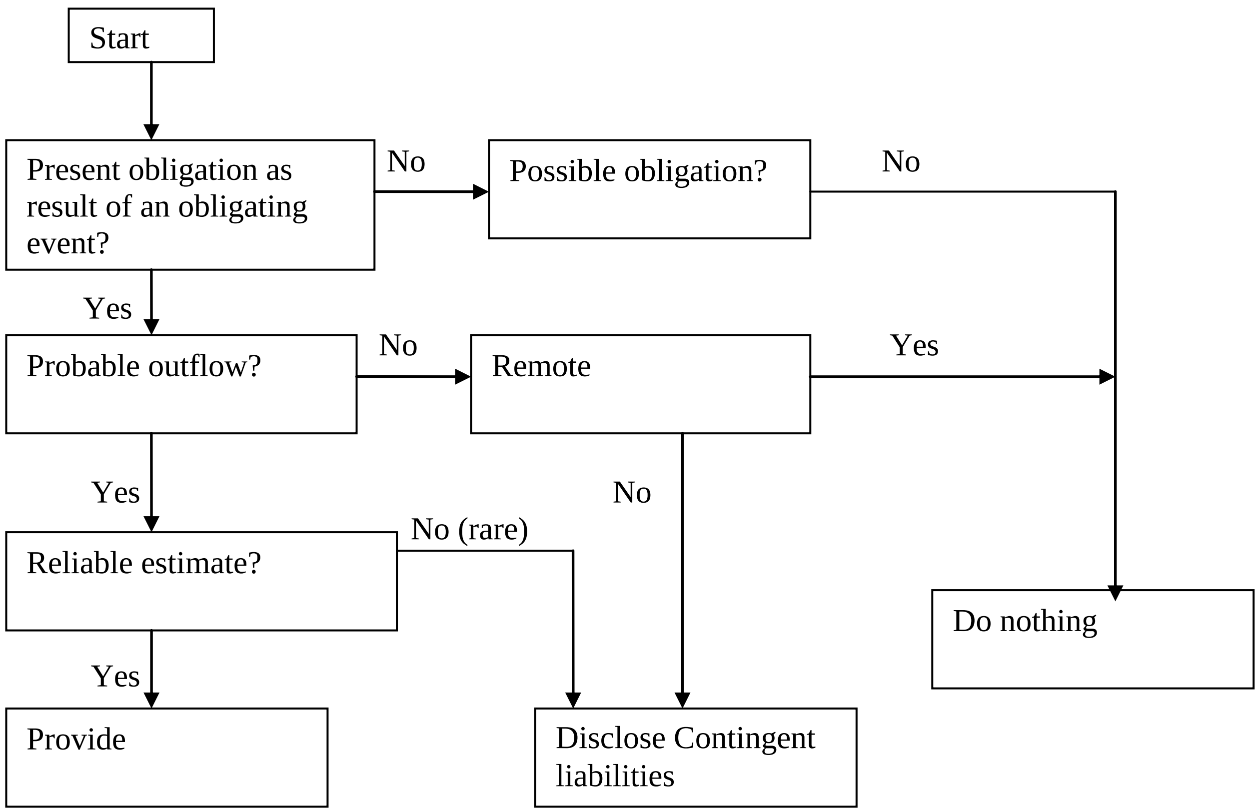
23 In case information as required is not disclosed because it is not practicable to do so, the fact should be stated.

Effective date

23. This Indian Government Financial Reporting Standard becomes effective for the Financial Statements covering periods beginning on 1st April of the year after the notification of the Standard by the Government. Till such notifications, these Standards would remain mandatory in nature to be used for guidance and pilot studies for accrual accounting.

Appendix A: Recognition trigger

The purpose of the decision tree is to summarize the main recognition requirements of the Accounting Standard for contingent liabilities. The decision tree does not form part of the Accounting Standard and should be read as guidance in the context of the full text of the IGAS.



Note: In rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligations if, taking account of all available evidence, it is more likely than not that a present obligations exists at the date of making Annual accounts.

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Appendix B: Few Examples

Example 1: A Court Case

After a collapse of a government building in 2009, ten people died. Legal proceedings are started seeking damages from the government but it disputes liability. Up to the date of approval of the financial statements for the year 31 December 2009, the government's lawyers advise that it is probable that the government will not be found liable since the building collapsed due to bad construction by the contractor of the building. However when the government prepares the financial statements for the year 31 December 2010, its lawyers advice that, owing to developments in that case, it is probable that the government will be found liable.

(a) At 31 December 2009

Present obligation as a result of a past obligating event – On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusions – No provision is recognized. The matter is not disclosed as a contingent liability unless the probability of any outflow exists.

(b) At 31 December 2010

Present obligation as a result of a past obligating event – On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlements – Probable.

Conclusion – Contingent liability is recognized for the best estimate of the amount to settle the obligation.

Example 2: Contaminated Land – Legislation Virtual Certain to be Enacted.

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 December 2009 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

Present obligation as a result of past obligating event – The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement – Probable

Conclusion: A provision is recognized for the best estimate of the costs of the clean-up.

Example 3: Staff Retraining as Result of Changes in the Income Tax system

The government introduces number of changes to the income tax system. As a result of these changes, the financial services sector will need to retain a large proportion of its administrative work force in order to ensure continued compliance with financial services regulation. At the date of closing of Accounts, no retraining of staff has taken place.

Present obligation as a result of past obligating event – There is no obligation because no obligating event (retraining) has taken place.

Conclusion – No provision is recognized (see paragraph 14 and 16-18)

Example 7: A Single Guarantee

During 2009, the Government gives a guarantee of certain borrowings of an entity, whose financial condition at that time is sound. During 2010, the financial condition of the entity deteriorates and at 30 June 2010, the entity goes into liquidation.

(a) At 31 December 2009

Present obligation as a result of a past obligating event – The obligating event is the giving of the guarantees, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement – No outflow of benefits is probable at 31 December 2009.

Conclusion – No provision is recognized. The guarantee is disclosed as a contingent liability only when there is a probability of any outflow.

(b) At 31 December 2010

Present obligation as a result of a past obligating event- The obligating event is the giving of the guarantees, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – At 31 December 2010, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion – A provision is recognized for the best estimate of the obligation.

Appendix C: Format for sector – wise disclosures for each class in the Financial Statements of the Union and State Government:

Sector-wise details for Contingent Liabilities

Sector wise (No. of cases of within bracket) Contingent liability	Estimated amount of contingent liability during the year (Rs.)	Outstanding at the beginning of the year (Rs.)	Addition during the year (Rs.)	Deletions/discharged during the year (Rs.)
1	2	3	4	5

Outstanding at the end of the year (Rs.)	Source of Fund discharge of liability		Nature of contingent liability	Other material details
	Contingency Fund	Consolidated Fund		
6	7	8	9	10

Sector – wise details for Contingent Assets

Sector wise (No. of cases of within bracket) Contingent Assets	Estimated amount of contingent Assets during the year (Rs.)	Estimated amount at the beginning of the year (Rs.)	Addition during the year (Rs.)	Deletions/earned during the year (Rs.)
1	2	3	4	5

Shortfall/ surplus at the end of the year (Rs.)	Details about assets earned credited to		Nature of contingent assets	Other material details
	Capital Receipt	Revenue receipt		
6	7	8	9	10