HM Treasury

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Dear Accounting Officer

FEES AND CHARGES AND OTHER ACCRUALS BASED ACCOUNTS: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS (FRS 12)

Purpose of this DAO

This letter explains how and when the new *Financial Reporting Standard "Provisions, Contingent Liabilities and Contingent Assets" (FRS 12)* should be implemented in accruals based accounts, including fees and charges accounts.

2. It applies to all trading funds and NDPBs which are outside the departmental boundary of the *Resource Accounting Manual (RAM)*; and any executive agencies which are not preparing their accounts for 1998-99 in full accordance with the *RAM* will nevertheless need to comply with this DAO. Other executive agencies and departments themselves, preparing their accounts in full accordance with the *RAM,* should already be applying *FRS 12,* but may also find it helpful to read paragraphs 11 to 21 of the annex attached, which are relevant to the application of the *RAM*, Section 7.3 "Insurance". (Section 4.3 of the *RAM* was amended to reflect *FRS 12* and the revised pages were circulated to members of the Resource Accounting and Budgeting Interdepartmental Implementation Group (RABIG) under cover of a letter dated 17 February 1999.)

Information

3. **Provisions.** *FRS 12* was issued by the Accounting Standards Board with the objective of ensuring consistency in the way in which provisions and contingencies are measured in accounts. The Companies Act 1985, Schedule 4, paragraph 89, enables provisions for liabilities and losses that are either likely or certain to be incurred. Essentially, *FRS 12* argues that losses and liabilities are not likely unless a past event has given rise to an obligation. It therefore states that provisions can only be charged to the operating (or income and expenditure) account when there is certainty of the existence of an obligation, because of a past event, although there is uncertainty as to timing and amount. Provisions set up under earlier and wider interpretations of "likely to be incurred"are therefore inconsistent with *FRS 12*.

4. The most common government example of an existing provision for probable future events which is inconsistent with *FRS 12* is notional insurance premiums and any provision on the balance sheet. However, notional insurance premiums will still need to be taken into account in setting fees and charges and insurance issues still need to be considered in relation to NDPBs funded through grant-in-aid. The annex explains how a note to the accounts or, where appropriate, a memorandum trading account should be used to note this.

5. Some government entities may also have other existing provisions which are inconsistent with *FRS 12* for example in relation to repairs and maintenance (except where required under a lease) or Year 2000 (except where necessary at the end of the year). Conversely, some may have obligations which are not treated as provisions at present, but which should be in future, for example provisions for dilapidations where it is a condition of the lease that the premises are maintained to a specific standard. The annex includes examples of potential existing or future provisions, and explains how to adjust accounts in respect of existing provisions which are inconsistent with *FRS 12* or, where necessary, to introduce new provisions under *FRS 12*.

6. **Contingent liabilities and contingent assets**. Under *FRS 12*, contingent liabilities and contingent assets relate to events too uncertain to be charged to the operating account but which should, where appropriate, be included in notes to the accounts. The amount disclosed under the "Government Accounting" rules on contingent liabilities (*Government Accounting,* Chapter 26) may not be directly comparable, so will continue to require separate disclosure (as noted for resource accounts in DAO(RAB)2/98 of 6 November 1998).

7. **DELs/EFLs**. Implementation of *FRS 12* in conjunction with the guidance on notional insurance premiums in this letter should mean that there are no implications for cash flow statements, or cash based controls such as Departmental Expenditure Limits (DELs) or External Finance Limits (EFLs) in the majority of cases. However, a few government entities may have other provisions which could have, for example, implications for the costing of fees and charges services. If these are significant enough to give rise to concern, their handling should be discussed with the sponsor department, or departments may wish to discuss it with the Treasury.

Timing

8. *FRS 12* came into effect for accruals based accounts in respect of the entity's financial year ending on or after 23 March 1999. For most entities, this will mean accounts for the year ending 31 March 1999. In this first set of accounts on the new basis, figures for the prior year (normally 1997-98) should also appear on the new basis.

Action

9. Departments are asked to note this letter, and to ensure that it is drawn to the attention of the executive agencies, trading funds and NDPBs for which they are responsible.

Enquiries

10. Departments should initially take up with their accountancy advisers any enquiries relating to the implications of *FRS 12*. Any general questions to the Treasury should be addressed to Nick Bailey in the Central Accountancy Team (0171 270 4535; GTN 270 4535), Questions on the policy on insurance should be addressed to Nick Towers in the Treasury Officer of Accounts Team (0171 270 5477; GTN 270 5477), or on fees and charges to Mary King in the same team (0171 270 5315; GTN 270 5315).

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ANNEX

FURTHER INFORMATION

Introduction

FRS 12 was issued on 17 September 1998 and became effective for financial years ending on or after 23 March 1999. Bodies will need to have regard to its requirements when preparing their accounts for 1998-99. *FRS 12* applies to all financial statements that are intended to give a true and fair view of their financial position at the year-end and of their results for the financial year. *SSAP 18 Accounting for Contingencies* has been superseded by *FRS 12*.

2. As this letter is not intended to give a comprehensive summary of the requirements of the standard, it is recommended that reference to the exact wording of the standard is made in cases of doubt.

Definitions

3. Some of the key definitions contained in *FRS 12*:

- ***Contingent Asset*** - 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 entity's control.

- ***Contingent Liability*** - (a) a possible obligation 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 entity's control; or

  (b) a present obligation that arises from past events but is not recognised because:

  (i) it is not probable that a transfer of economic benefits will be required to settle the obligation; or

  (ii) the amount of the obligation cannot be measured with sufficient reliability.

- ***Executory contract*** - one under which neither party has performed any of its obligations, or both parties have partially performed their obligations to an equal extent.

- ***Onerous contract*** - one in which the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received under it.

- ***Provision*** - a liability of uncertain timing or amount [but whose existence is certain because of a past event].

4. Other definitions used in this annex:

- ***Income and expenditure account*** - an accounting statement also known in the *RAM* as the operating cost statement and in some account formats as the profit and loss account.

- ***General Fund*** - a reserve, also known in some formats as the income and expenditure reserve, general reserve, or accumulated surpluses.

- ***Recognition*** - narrowly defined in accountancy terms as when an item is taken into account in one of the one of the main statements of the accounts (but government entities may well need to be aware of, and to mention in the notes to the accounts, items which do not get recognition in this narrower sense).

Provisions

Recognition - general considerations

5. The main feature of *FRS 12* is that a provision should be recognised (ie by charging amounts to the income and expenditure account and crediting the relevant heading in the balance sheet) only when a body:

- has a present obligation (legal or constructive) as a result of a past event;
- it is probable that a transfer of economic benefit will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

This means that it will no longer be possible to make a provision for costs which *might* be incurred in future for, for example, refurbishment costs or for self-insured losses where a body self insures.

6. The requirements of the *FRS* do **not** apply to provisions, contingent liabilities or contingent assets which:

C result from financial instruments which are carried at fair value;
C result from executory contracts except where the contract is onerous;
C arise in insurance entities from contracts with policy-holders;
C are covered by more specific requirements in another *FRS or SSAP* - this will include long-term contracts (covered by *SSAP 9*); deferred taxation (*SSAP 15*); leases (*SSAP 21*, unless an operating lease has become onerous) and pension costs (*SSAP 24*).

Measurement

7. The amount of the provision should be a realistic and prudent estimate of the expenditure required to settle the obligation at the balance sheet date.

Discounting

8. Where the liability extends over a number of years, the amount of the provision should be discounted where this has a material effect. The standard public sector rate - currently 6 per cent in real terms - which is, for all practical purposes, risk free should be used. *FRS 12* provides alternative methods of discounting provisions but this is the method to be adopted in government accounts in the interests of consistency. Further guidance on discounting is given in section 4.3 of the *Resource Accounting Manual* and in *Economic Appraisal in Central Government - A Technical Guide for Government Departments (“the Green Book”).*

9. As the present value of the provision is reassessed each year, the amortisation should be treated as an interest charge in the income and expenditure account, but separately identified.

Disclosure

10. The notes to the accounts should disclose the amounts of each material class of provision and movements in the year - further details are given in paragraphs 89-97 of *FRS 12* - but see also paragraphs 35 and 36 below about exceptions from disclosure.

Practical examples

(a) Insurance (particularly relevant to fees and charges)

11. Notional insurance premiums are the most common government example of an existing provision for probable future events. The introduction of *FRS 12* has no impact on the Government's policy, set out in *Government Accounting* chapter 27, of using self-insurance where it would not represent value for money to take out commercial insurance. Notional insurance premiums should continue to be taken into account in setting fees and charges. This ensures that the level of fees is indifferent to whether self-insurance or commercial insurance is used (for example, in any comparison with private service providers); and provides evidence that, for example, any claims in respect of third party losses will be dealt with appropriately.

12. The guidance in chapter 27 (for departments, including executive agencies, and NDPBs) and in chapter 17 (for trading funds) on how to assess the appropriate level of notional insurance premiums is also unchanged, as is the guidance in those chapters on how to proceed with funding decisions when a self-insured loss has occurred, or a third party claim is received. However, the way in which government entities account for notional insurance premiums, and for any existing insurance provision on the balance sheet, will need to change to take account of *FRS 12*. *Government Accounting*, paragraph 27.3.18(b) on executive agencies; and Chapter 17, Annex 17.1 on trading funds; and the accounting guidance for NDPBs, will be amended in due course to reflect the implementation of *FRS 12*.

13. Any executive agencies still following accounting guidance which pre-dates the *RAM*, and all trading funds and NDPBs will need to adopt a broadly similar procedure to that set out for resource accounts in the *RAM* section 7.3. This says that notional insurance premiums will not be charged to the operating (ie income and expenditure) account except in the case of the Intervention Board. (The reasons for this exception are explained in the *RAM*.)

14. Instead, cash expenditure on accident repairs, third party claims, etc appropriate to be charged to the income and expenditure account should be charged to it, as should the write down or write off of the value of a fixed asset on the balance sheet; and there should be no provisions for self-insurance in the balance sheet. (Whether the cost of repair/replacement of a fixed asset is charged to the income and expenditure account will depend on the method of funding the cost, eg from the entity's existing resources or, where necessary and appropriate, from, eg, additional borrowing or capital grant in aid. However, the charge of write down/off of fixed assets applies whether repair/replacement will be funded from the entity's own resources or from external sources, or the asset not replaced.)

15. Only if a loss has already occurred but the amount cannot be determined until the

following financial year, should the best estimate of the amount be charged to the account and a provision set up in the balance sheet.

16. However, as notional insurance premiums will continue to be taken into account in costing fees and charges services, income from fees and charges in the account will still reflect them. The *RAM* says that entities expected to recover full costs, in accordance with the Treasury's fees and charges policy, may show in a note to the accounts the effect of charging notional insurance premiums.

17. When should a note on notional insurance premiums appear in the accounts? Where income from fees and charges is material to the entity's published accounts, a note to the accounts should give the position adjusted for notional insurance premiums. Where it is not material, or for those commercial activities where prices are appropriately set at more than full costs, notional insurance premiums could be included instead in management accounts such as memorandum trading accounts; although the entity may wish to include mention of the premiums in the notes on the transition to *FRS 12* (see paragraphs 28 - 30 below) but keep the record internally in future years.

18. What should be the content of the note? The note to the accounts should indicate how costs would have been affected and what the surplus or deficit on the account would have been if costs had been shown to include notional insurance premiums and to exclude actual losses etc in respect of self insured matters. (It would be inappropriate to take both losses and notional insurance premiums in to account in setting fees and charges as that would involve some double counting.) It is this adjusted position which should be used when assessing the size of surpluses or deficits for fees and charges purposes and for demonstrating, when necessary, that statutory services, and those other services which should not be set to recover more than full costs, are not overcharging. (See the *Fees and Charges Guide* for guidance on the recovery objectives for different types of fees and charges.)

19. On the balance sheet, any existing insurance provisions which do not meet *FRS 12* will be removed and, in effect, absorbed into the General Fund. Information on the extent to which the entity is expected to meet insurance losses from within its own resources, which may include an indication of how much of its cash balances and other assets it is reasonable to consider are held for meeting insurance losses, may be kept in internal management accounts or other documents. Exceptionally, if an amount of the assets is indicated which is material in comparison to the size of the General Fund, this could be mentioned in a note to the accounts. However, in that case, although <u>catastrophic</u> risks should be taken into account in assessing the notional annual premium to ensure that prices reflect the full cost of supplying services, the level recorded in the note should not exceed the level which would be adequate to cover self-insured losses which it would be reasonable to assume might occur in any one year and such losses would necessarily exclude catastrophic losses.

20. Where NDPBs are financed primarily by grant-in-aid, the normal level of losses from self-insured risks experienced by the body may be one of the costs taken into account in considering the level of grant-in-aid. *Government Accounting*, paragraph 27.4.7 sets out the insurance issues to be covered in the conditions attached to grants-in-aid.

21. The guidance in paragraphs 11 to 20 is subject to the overriding proviso that when fees and charges are set by statute, or entities are established under statute, the statutory requirements

must be observed and may, in some instances, require some exceptions from the procedures outlined in those paragraphs.

(b) Refurbishment costs

22. *FRS 12* will not permit the establishment of provisions in respect of refurbishment or major refits as the intention, or even necessity, to incur expenditure in the future is not sufficient to give rise to an obligation. Instead, the standard recommends the adoption of a depreciation policy which recognises that the consumption of the economic benefits provided by the asset has been accelerated. Thus, if an asset has a useful economic life of, say 25 years, but is refurbished after 12 years, it should be depreciated (in whole or in part, if only some of the asset is to be refurbished) over 12 years with the cost of the refurbishment being capitalised as it restores the previously consumed economic benefits. The overall effect on the income and expenditure account is the same as the previous costs of establishing the provision are replaced by higher depreciation charges.

23. However, where a body leases premises or other assets from a third party and, as part of the leasing contract, it is obliged to maintain the premises in a satisfactory condition, it must make the necessary provisions for ***repairs and (where appropriate) dilapidations*** to cover the refurbishment as it is under a legal obligation to transfer future economic benefits. Bodies which both rent and own various premises may find that they are obliged to recognise provisions for some properties, but are prevented from so doing in the case of other properties.

(c) Other practical examples

24. In addition to the examples of self-insurance and refurbishment costs (discussed above), the standard gives practical examples relating to:

- warranties
- contaminated land
- offshore oilfield (removal of the rig and restoration of the seabed) - also of relevance to decommissioning costs
- refunds policy
- closure of a division - both where the decision has been made before the balance sheet date and after that date
- requirement to fit smoke filters
- staff retraining
- onerous contracts
- single guarantees
- a court case

25. Reference to these examples should be made if it appears that they have relevance in any particular circumstances. Further information on ***decommissioning costs*** is given in section 4.4 of the *Resource Accounting Manual* and will be relevant even if the body is outside the resource accounting boundary.

26. The standard makes it clear that a body should not provide in its accounts for a period for ***future operating costs*** ie those which need to be incurred to operate in a future period if those costs could be avoided by the body's future actions. Provisions can be recognised only if an

obligation exists at the balance sheet date and not simply because a programme of expenditure has been identified. This requirement may have implications for costs to be incurred to ensure Year 2000 compliance, or for introduction of the euro as it will not be possible to set up a provision in anticipation of the need to incur expenditure in future. The *Urgent Issues Task Force's Abstracts* 20 and 21 (respectively *Year 2000 issues: accounting and disclosures* and *Accounting issues arising from the proposed introduction of the euro*) are both of relevance.

Return on capital employed

27. A number of organisations have targets set in terms of the return on capital employed (ROCE). The ROCE is the surplus on ordinary activities disclosed in the income and expenditure account (before long-term interest, distributions and appropriations) expressed as a percentage of the capital employed (fixed assets and current assets less current liabilities). It is possible that the surpluses shown in the income and expenditure account will fluctuate more as a result of charging losses as they occur instead of notional insurance premiums. The ROCE, however, seems unlikely to be significantly affected unless there are significant losses in any year. Where necessary, the effect of losses could be mentioned when reporting achievement against the ROCE target as could any other effects from implementing *FRS 12*.

Transition to FRS 12

28. Paragraph 102 of *FRS 12* makes it clear that those existing provisions which are inconsistent with *FRS 12* should be written back as no longer required. This is a change in accounting policies and should be treated as a prior year adjustment in accordance with FRS 3. Thus the current and prior year's figures (1998-99 and 1997-98) will need to be restated to reflect the new accounting policy. Figures for the operating surplus/deficit and balance sheet of the year before (1996-97) should also be re-worked but it is not necessary to re-publish this year - its purpose is purely in order to calculate an adjustment to the opening reserves of the prior year for the notes to the accounts. In simple cases, where there is no overall effect on the net asset position, the effect of making the prior year adjustment is that the difference of surplus/deficit on the restated income and expenditure account, and any separately identified provisions on the balance sheet which are no longer required, will be reflected in a difference in reserves in the General Fund.

29. Where any new provisions have to be added as a result of *FRS 12*, eg where there is a legal obligation under a leasing contract to maintain the asset in a satisfactory condition (see paragraph 23 above), and a provision would also have been required in the prior year had *FRS 12* been in operation then, the current and prior year should be re-stated to reflect the new accounting policy. Use a similar procedure as in the paragraph above (except that the provision is included instead of removed). Where there are both provisions to be written back and new to be added, both should be reflected in the accounts.

30. In the notes to the accounts, there should be a note in the section dealing with accounting policies recording that action has been taken to bring the accounts into line with *FRS12* and, as indicated above, there should also be a note supporting the General Fund which records the adjustment which has been made to the opening reserves of the prior year.

Contingent liabilities

Recognition

31. Contingent liabilities should not be recognised. However, if it becomes probable that a transfer of future economic benefits will be required in respect of an item previously dealt with as a contingent liability, a provision should be recognised in the financial period in which the change in probability occurs.

Disclosure

32. Contingent liabilities should be disclosed by way of note. The note should briefly describe the nature of the contingent liability and give, if practicable:

- an estimate of its financial effect;
- an indication of the uncertainties relating to the amount or timing of any outflow; and
- the possibility of any reimbursement.

If any of this information is not disclosed because it is not practicable to do so, this fact should be stated, but see also paragraphs 35 and 36 below.

Contingent assets

Recognition

33. Contingent assets should not be recognised, because it could result in a profit which may never be realised. If it becomes virtually certain that an inflow of economic benefits will arise in the case of a contingent asset previously disclosed by way of note, the asset and the related profit should be recognised in the financial period in which the change occurs.

Disclosure

34. A contingent asset is disclosed by way of note where an inflow of economic benefits is probable. The note should briefly describe the nature of the contingent asset at the balance sheet date and, where practicable, an estimate of the financial effect. If any of this information is not disclosed because it is not practicable to do so, this fact should be stated, but see also paragraphs 35 and 36 below.

Exception from disclosure

35. In extremely rare cases, disclosure of information about provisions, contingent assets and liabilities can be expected to prejudice seriously the position of the body in a dispute with a third party. In such cases, the body need not disclose some or all of the information unless its disclosure is required by law. However, the general nature of the dispute and the fact that, and the reason why, the information has not been given should be disclosed.

36. Under existing reporting procedures in *Government Accounting* chapter 26 (which continue in addition to the requirements under *FRS 12*), there are arrangements for disclosing information to the PAC on a confidential basis so long as certain conditions are satisfied. There

is thus a possibility that information will be in the public domain through the Parliamentary procedures, although not disclosed in the accounts. It is also possible that amounts discussed under chapter 26 may not be directly comparable to those noted under *FRS 12*. The Treasury Officer of Accounts team should be consulted if the differing requirements of Parliamentary reporting and those of the accounting standard are likely to cause difficulties.

Further guidance

37. For further information about the implications of *FRS 12* reference should be made to the standard itself - copies can be obtained from ASB Publications, PO Box 939, Central Milton Keynes, MK9 2HT (telephone 01908 230344). It costs £8.00 post free and its ISB number is 1 85712 073 6. Please note that the Treasury cannot provide copies of the standard.