

Guidance on Recognising Liabilities and Expenses

November 2013



THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Government

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About this guidance

This guidance document sets out when to recognise a provision for a liability of uncertain amount or timing for financial reporting purposes, particularly when that is for an obligation which is not “exchanged”. This document summarises GAAP, provides application guidance with a focus on non-exchange transactions in particular, and provides examples illustrating when it is appropriate to recognise provisions and constructive obligations.

This guidance document should be read by those responsible for accounting policies and for the preparation of general purpose financial reports in the public sector in New Zealand.

The guidance outlined in this document applies to financial statements for periods beginning on or after 1 July 2013.

The guidance outlined in this document applies until this document is updated or replaced. This document will be reviewed following changes in the financial reporting standards that are referenced in this document.

This document has been written by the Fiscal Reporting Team in the Treasury with the assistance of the Office of the Controller and Auditor General.

Questions and feedback

You should use this document as your first point of call when making accounting judgements over when to recognise a provision for a liability of uncertain amount or timing for financial reporting purposes, particularly when that is for an obligation which is not “exchanged”.

General enquiries about the information contained in this guidance, not addressed in this guidance or the associated FAQs, can be directed to ken.warren@treasury.govt.nz.

Any agency-specific questions should be addressed to your Treasury Vote team.

Any comments as to how we could improve this guidance can be directed to guidance@treasury.govt.nz.

Introduction and purpose

1. One of the most common issues encountered in public sector accounting is when to recognise a provision for a liability of uncertain amount or timing, particularly when that is for an obligation which is not “exchanged”¹. This is an area that often requires significant judgement, and therefore it is an area where inconsistencies can develop. For entities within the whole of government reporting entity, this is an issue as they can be surprised in being required to recognise a liability at time of audit, resulting in the need to report unappropriated expenditure; at the consolidated level there can be issues arising in making appropriate elimination entries – for example when a grant receivable is not matched with a grant payable.
2. The practical difficulties involved in obtaining clear and consistent direction on this issue is being considered by standard setters. Options being debated include whether enforceability (however defined) of the obligation against the Government should be considered an essential characteristic of a liability, or alternatively whether separate rules should be established for exchange and non-exchange transactions (with constructive obligations not being applicable to non-exchange transactions). However, the resolution of these debates, and the implementation of such resolutions through changed accounting standards, is still a number of years away. In the meantime, the existing standards need to be applied. Guidance is therefore required in the interim until new standards emerge.
3. The purpose of this document is to provide such interim application guidance to operationalise current standards so that practice is both compliant with Generally Accepted Accounting Practice (GAAP) and that consistent treatment is followed. This document summarises GAAP, provides application guidance with a focus on non-exchange transactions in particular, and provides examples illustrating when it is appropriate to recognise provisions and constructive obligations.

Generally accepted accounting practice

4. NZ IAS 37 (and PBE IPSAS 19) states that a provision shall be recognised when
 - An entity has a present obligation (legal or constructive) as a result of a past event;
 - It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
 - A reliable estimate can be made of the amount of the obligation.
5. If these conditions are not met, no provision shall be recognised.

¹ A transaction is not considered an exchange transaction when an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without receiving approximately equal value in exchange (IPSAS 9).

6. NZ IAS 37 (and PBE IPSAS 19) states that in almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the end of the reporting period by taking account of all available evidence, including, for example, the opinion of experts.

7. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

- where the settlement of the obligation can be enforced by law; or
- in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

8. Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's statement of financial position are those that exist at the end of the reporting period and meet the recognition criteria set out in paragraph 4.

9. It is only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) that are recognised as provisions. Because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

10. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

11. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

12. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted. For the purpose of this guidance, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

13. The above requirements shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets with one exception in the case of the Crown. In the case of the Crown NZ IAS 37 (and PBE IPSAS 19) shall not be applied in accounting for obligations expressed in legislation that have characteristics similar to an executory contract².

Crown Accounting Policies

14. The Government has operationalised the above requirements in GAAP through the Crown Accounting Policies that are included in the Financial Statements of Government and Treasury Instructions (references to Treasury Instructions below in brackets):

15. Relevant statements in the Crown Accounting Policies include:

Expenses must be recognised in the period to which they relate. (3.5.4.1)

Welfare benefits and entitlements, including New Zealand Superannuation, must be recognised in the period when an application for a benefit has been received and the eligibility criteria met. (3.5.4.2)

Where grants and subsidies are discretionary until payment, the expense must be recognised when the payment is made. Otherwise, the expense must be recognised when the specified criteria have been fulfilled and notice has been given to the Crown. (3.5.4.3)

Application guidance

16. This application guidance is focussed on determination of the present obligation (legal or constructive) as a result of a past event. Despite the NZ IAS 37 (and PBE IPSAS 19) assertion that in most cases it will be clear whether a past event has given rise to a present obligation, experience has shown this is not as common as the standard suggests.

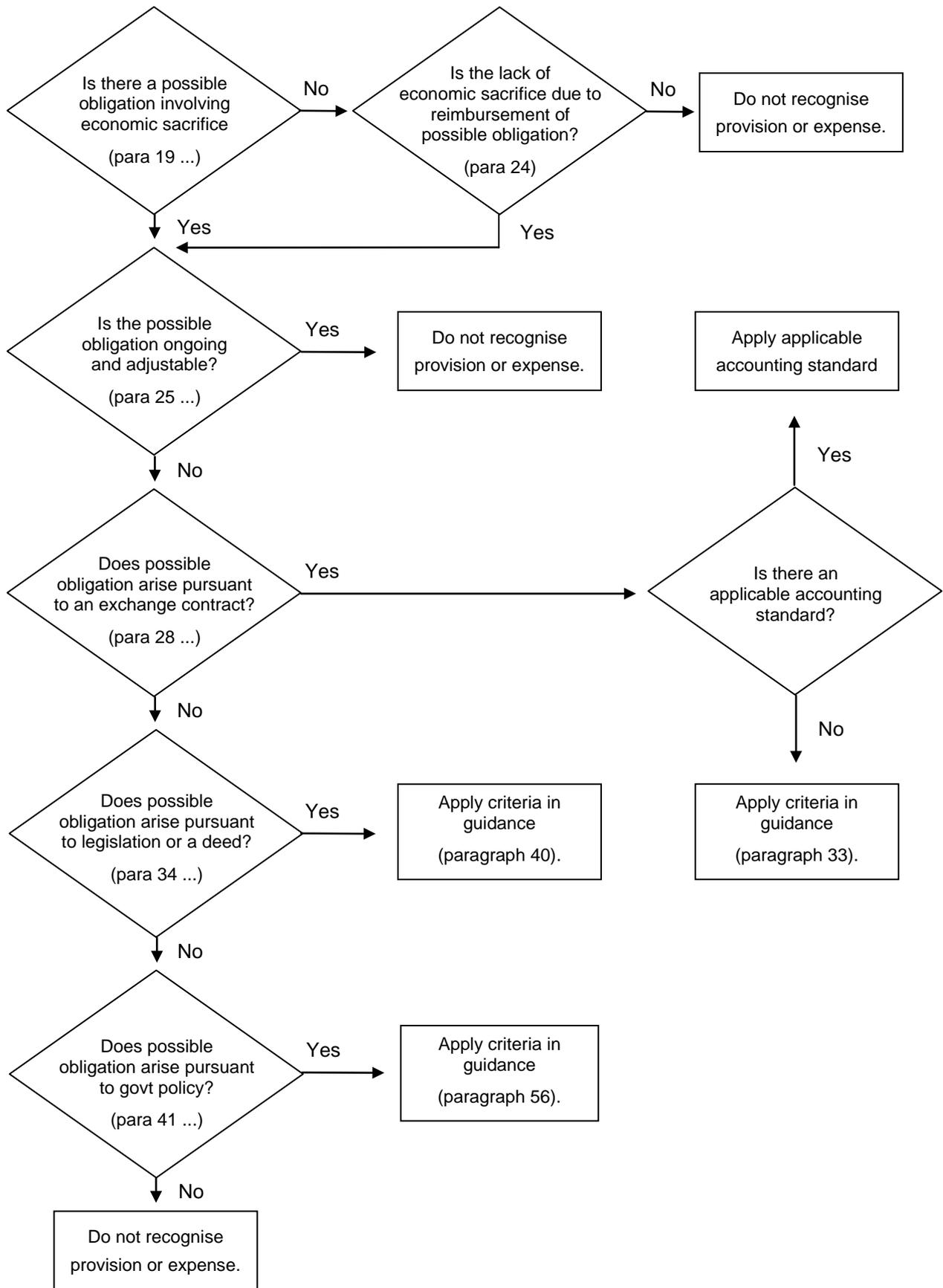
17. Practically, obligations can arise:

- pursuant to an exchange contract,
- pursuant to a legally actionable statute or deed of agreement, or
- as a result of a policy being pursued by the Government.

18. The guidance follows a logic path that firstly tests whether a possible obligation involves economic sacrifice. If there is no economic sacrifice, there is no expense or liability to be recognised. It then tests whether the obligation is ongoing and adjustable. In such cases the obligation is best considered a future rather than a present obligation. Following that the guidance considers each of the three possible circumstances above in which an obligation can arise. The decision chart below shows how this is mapped out in the document.

² Obligations of the Crown expressed in legislation that have characteristics similar to an executory contract are those where:

- (a) the Crown is obligated to provide goods, services or transfers to the community in future periods using funding to be obtained from the community substantially in those future periods; and
- (b) the intended third party recipients of the goods, services or transfers have not yet satisfied the criteria for entitlement to those goods, services or transfers.



Is there a possible obligation involving a (net) economic sacrifice?

19. In most cases it is the possible existence of an economic sacrifice that raises the question as to whether there is a present obligation and therefore a liability. If there is no economic sacrifice there can be no expense. However, in some cases the reporting entity will consider there is no economic sacrifice because the costs involved in meeting the liability will be reimbursed.

20. NZ IAS 37 (and PBE IPSAS 19) do not require an expense to be reported for any provision for a future sacrifice where it is virtually certain that the economic sacrifice will be reimbursed. However, in such cases the provision for costs and the reimbursement asset must be reported gross. Therefore, a judgement is required as to whether the lack of economic sacrifice is due to the reimbursement of a possible obligation, or to put it another way, whether the cost is being incurred by the entity as an agent acting for a separate principal.

21. A number of government programmes are designed as “funded” programmes where the service recipients fund the government expenditures. It may be argued in such cases that the Crown is merely operating as agent for the service recipients. However, to make such a case, a judgement is necessary as to whether the funding of the expenditure is sufficiently tightly integrated with the incurrence of the expenditure, and sufficiently certain, that it is more true to state that the economic sacrifice, and therefore the expense, lies with those funders of the service rather than the Crown.

22. Clearly, costs to be met from general tax revenue (such as healthcare or income support entitlements) have insufficient certainty and insufficient integration between revenue and expense to allow them to be offset. On the other hand it would not be appropriate to report as an expense a present obligation to incur costs, funded by a special levy that is virtually certain to be collected in the future, which relieves the Crown (as agent) of adverse financial consequences, by transferring the cost onto others (the principals).

23. The following criteria, if they are all met, will mean that an expense need not be reported at the time a possible obligation is entered into.

24. Criteria to use in determining if an expected reimbursement is sufficiently certain and sufficiently integrated with the expense to avoid recognising an expense:

- There are effective mechanisms to ensure expenditure will not be incurred without the revenue being levied; and
- There are effective mechanisms to prevent revenue levied being used for other activities; and
- There are past practices of applying the revenue to the expense; and
- The expectations of those paying for the expense are such that they recognise that they bear the risks associated with changing obligations, rather than the Crown.

Is the possible obligation ongoing and adjustable?

25. An expected future sacrifice does not of itself mean that there is a present obligation. Indeed, forecast expenses cannot by definition be a present obligation – if they were, the expense would be an actual rather than a forecast expense. Recognising this, the accounting standards exclude future operating losses (NZ IAS 37.63, PBE IPSAS 19.73) from being provisioned, and the guidance on restructuring excludes costs relating to the ongoing activities of the entity from being included in a provision. To narrow the focus to those cases where a possible obligation is a present obligation and expense, it is therefore sensible to exclude these items where the obligation clearly arises in the future.

26. Expenses that are clearly adjustable and ongoing fall into this category. If it is within the discretion of the Government to adjust the timing or nature of the costs that will be incurred in the future, and if the activities are expected to occur on an ongoing basis before and after the reporting date, then the fact of the reporting date should not cause a present obligation to be reported. Notwithstanding that it might be argued that the Government has an obligation to provide education, healthcare, policing services etc, the fact that such obligations are ongoing and adjustable means they can be excluded from consideration as a liability to be reported when a child is born, when sickness occurs or when a crime is committed etc. The expenses related to such services will rather be reported in the year in which they are incurred.

27. This guidance also takes the view that it is not open for the Government or a public sector entity to shift the recognition point of such activities by, for example, guaranteeing that ongoing adjustable activities will occur, or creating a special-purpose-vehicle to undertake the activities. Unless the “ongoing” and “adjustable” nature of the activity is irrevocably changed, such activity should still be reported in the year in which the economic sacrifice occurs.

Does an obligation arise pursuant to an exchange contract?

28. For obligations that arise as a result of an exchange contract, the contract specifications have the impact of reducing uncertainty and therefore reducing the need for judgement in determining when obligations are created.

29. Not all contracts are exchange contracts, whereby an entity directly exchanges approximately equal value (e.g. in cash goods services, or use of assets) with another entity. In the case of an agreement where services are expected to be provided as a result of the funding received, the agreement is to be treated as an exchange contract if the following three conditions are all met:³

- The services are clearly specified, and
- The value of services is approximately equal to the funding, and

³ These tests are drawn from the FRSB’s supplement to the G4+1 paper on non-reciprocal revenue (1999)

- The funding that has been provided is conditional on the service to be supplied

If any of these conditions are not met, then the possible obligation does not arise pursuant to an exchange contract and the other causes for the possible obligation in the decision chart should be explored.

30. Exchange contracts will specify performance by both parties to the contract. It is usual in such cases to report the obligation (and the associated expense) that arises on the performance of the other party. Thus the obligation for a maintenance contract is reported over the period that the maintenance service is provided, and an employee obligation is reported as the employee provides service, notwithstanding the existence of the original contract. Agreements equally proportionally unperformed, are not reported as liabilities (and expenses) and assets (and revenues), but rather the commitment will need to be reported where this is required under an accounting standard (in the case of construction or acquisition of Property Plant and Equipment, or of leases). The general accounting policy description usually given for following this practice is that “Expenses are recognised as they are incurred (or, “expenses are recognised in the period to which they relate.”)

31. Those exchange contracts where risks, other than financial risks, are transferred from one party to another are considered insurance contracts, and NZ IFRS 4 (PBE IFRS 4) applies. Financial risks are most commonly transferred through derivative contracts and NZ IAS 39 (PBE IPSAS 30) applies to the measurement and recognition of such obligations. Accounting standards also provide detailed guidance where performance is contingent (e.g, refer NZ IFRS 3 (PBE IFRS 3) for contingent consideration of acquisitions, NZ IAS 17 (PBE IPSAS 11) for contingent rent and NZ IAS 37 (PBE IPSAS 19) for warranties and NZ IFRS 4 (PBE IFRS 4) for insurance contracts).

32. Given that coverage, this document does not provide any additional guidance on obligations arising as a result of contracts, other than to articulate the general rule where there is not a specific standard covering the contract.

33. Criteria to be used for determining when a present obligation arises pursuant to an exchange contract

- Specific accounting standards should be followed where applicable. Such standards include: NZ IFRS 4 (PBE IFRS 4) for insurance contracts, NZ IAS 39 (PBE IPSAS 30) for financial instrument contracts, NZ IFRS 3 (PBE IFRS 3) for entity acquisitions, NZ IAS 17 (PBE IPSAS 11) for lease contracts and NZ IAS 37 (PBE IPSAS 19) for warranties.
- In the absence of a specific accounting standard, the performance of other parties to the contract will be the obligating event that leads to a present obligation.

Does an obligation arise pursuant to legislation or deed of settlement or agreement?

34. The Government frequently takes responsibility for the provision of assistance to individuals. Such assistance may be to rectify individual's circumstances or losses incurred as a result of adverse events, or may be to encourage them to undertake beneficial activities. The Government may discharge these responsibilities through the form of cash transfers, concessionary loans or guarantees, or free or subsidised goods or services. The goods or services could be directly provided to the community as a whole, to individual businesses, non-profit organisations or to individuals directly.

35. If legislation or a deed of agreement provides individuals or entities with the right to take legal action against the Government to obtain payment of cash transfers or delivery of goods and services, a present obligation (legal) exists at the point that:

- an event meeting the criteria in the legislation or deed has occurred; and
- individuals or entities satisfying the criteria to receive the assistance exist, and
- those recipients have no further substantial acts to complete before receiving the assistance.

36. Determining whether there are "substantial acts to complete" may require judgement. Some types of assistance may involve a series of substantial events. For example funding may increase as other financial support for a project is obtained. If a grant recipient has raised \$75,000 externally at the reporting date and has a deed of agreement from the Government for one-for-one funding up to \$100,000, then the Government should only recognize an obligation for its \$75,000 at the reporting date, even if it is likely that \$100,000 will be raised, and an additional \$25,000 will become owing. Conversely, if the only act required prior to receipt of the assistance, is the completion of necessary paperwork, this should not be regarded as a "substantial act to complete" in the terms of paragraph 35.

37. This approach is in accord with the NZ IAS 37 (and PBE IPSAS 19) exclusion of legislated social policy obligations which have characteristics similar to an executory contract (see paragraph 13 and footnote). It also applies a harmonized approach to legally actionable agreements and contracts.

38. The present obligation, because it is actionable, exists independently of whether or not the government has sufficient budgetary authority to meet its obligation to provide assistance⁴. Not having an appropriation in this instance is therefore not an impediment to recognising the obligation. If there is no appropriation, then a breach of the Public Finance Act has occurred.

⁴ See *New South Wales v Bardolph* (1934) where the NSW Govt attempted to argue it was not obligated to settle a contractual obligation because of the absence of an appropriation. The court held "it would be an extraordinary, if not disastrous, doctrine if the law is, as the Crown contends, that there is not a single contract made by the Crown with a subject is enforceable against the Crown, and every payment made thereunder is recoverable back from a subject, unless a clear reference to payments under a particular contract is contained in an Act of Parliament."

39. Announcements by a government regarding its intention to change the level of assistance would not alter the point of recognition of a present legal obligation if the government requires legislative or regulatory change to put its intention into effect unless the passing of such legislation was virtually certain, and the other criteria were met.

40. Criteria to be used for determining when a present obligation arises pursuant to legislation, deed of settlement or deed of agreement:

Where individuals or entities have the right to take legal action against the government to obtain payment of non-reciprocal cash transfers or delivery of goods and services, the criteria to be used for determining if a present obligation (legal) exists are:

- an event meeting the criteria in the legislation or deed has occurred; and
- individuals or entities satisfying the criteria to receive the assistance exist; and
- those recipients have no further substantial acts to complete before receiving the assistance.

Does an obligation arise pursuant to a policy being pursued by the Government?

41. Where the government has an established policy (not in legislation, or a legally actionable document) for specific circumstances, containing clear details of eligibility criteria and the type and amount of expenditure to be provided, in certain circumstances, individuals or entities meeting the criteria could argue that the government has a constructive obligation to them in accordance with that policy.

42. NZ IAS 37 provides guidance on the application of the recognition and measurement rules for provisions for certain constructive obligations, including restructuring. NZ IAS 37 paragraph 72 (PBE IPSAS 19 para 83) provides guidance on the circumstances in which a constructive obligation for restructuring exists (refer box below). This guidance establishes principles that are useful in determining whether a government has a constructive obligation for other types of claims.

Restructuring – NZ IAS 37 para 72 (PBE IPSAS 19 para 83)

A constructive obligation to restructure arises only when an entity:

- a) has a detailed formal plan for the restructuring identifying at least:
 - i) the activity/operating unit or part of an activity/operating unit concerned;
 - ii) the principal locations affected;
 - iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
 - iv) the expenditures that will be undertaken; and
 - v) when the plan will be implemented; and
- b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

43. These criteria focus on the need for evidence that the entity with the obligation is likely to act on its intention to provide resources to another entity such that a valid expectation is created and the entity cannot realistically avoid settlement. The criteria are intended to provide more detailed guidance than the definition of a provision itself and thereby improve the consistency and comparability of reported information. However, the recognition of such constructive obligations is still governed by the definition of an obligating event, which requires that an entity has no realistic alternative to settling the obligation. To make a judgement on this the critical evaluation that is required is whether the formal plan ((a) above) is sufficient for a valid expectation ((b) above) to exist. Rewording these criteria, in the context of Government assistance, suggests the following:

44. A non-exchange constructive obligation arises only when:

a) the government has a detailed formal policy identifying at least:

- i) which public sector entity will provide the assistance;
- ii) what events qualify for assistance;
- iii) the types and approximate number of entities who will receive assistance;
- iv) the estimated cost; and
- v) when the assistance will be provided; and

b) has raised a valid expectation in those affected that it will provide assistance by starting to implement that plan or announcing its main features to those affected by it.

45. These criteria however need to be developed further to take into account two particular circumstances of the Crown that affect valid expectations of third parties:

- Assessing the power of the Crown to realistically avoid the economic sacrifice.
- The interplay between the “plan to provide assistance” and the “financial plan” or budget constraints the Government works under.

46. On the first point, the valid expectation of third parties that prevent the Crown from realistically being able to avoid the economic sacrifice, must be tempered by the knowledge that Government policy is subject to change. Institutional Economic theory describes this as the credible commitment problem of governments. One method that governments use to overcome the credible commitment problem is to entrench their policy in legislation, in which case the previous section of this guidance applies. Absent legislation, other criteria are needed that recognizes this governmental issue.

47. The previous “Old GAAP” NZ Conceptual Framework refers to “*legal, social or political consequences of failing to act or perform in the agreed way ... such that the entity is left with little, if any, discretion to avoid the sacrifice.*” (highlights added). Whenever a policy is changed, significant legal, social or political consequences are likely to follow, and are only likely to follow, if the change is seen as being inequitable.

48. Issues of equity have been addressed through tort law. The legal doctrine of promissory estoppel has developed in recognition of this point, and is a useful way of operationalising these issues in a manner that consistent judgements will follow. Promissory estoppel is a legal doctrine whereby recovery is allowed on a promise made without consideration when the reliance on the promise was reasonable, and the promisee relied to his or her detriment. This tort has developed to cope with situations when injustice can be avoided only by

enforcement of a non-enforceable promise. It has for example been used to enforce charitable gift pledges, but only where the charity can show it has relied on them to its detriment.

49. The doctrine of promissory estoppel is therefore useful in forming an accounting judgement as to whether the Government has any realistic alternative to settling the obligation. It provides a basis for determining whether the Government can, in equity, withdraw from the obligation without social or political consequences. It suggests that only where the third party has relied on a promise to its detriment, can it claim a valid expectation that a government promise (absent legislation) cannot be withdrawn.

50. A third party can claim it has relied on a promise to its detriment in the following two cases:

- when the entity has been impacted by events covered by the policy, or
- when the entity, has as a result of the policy, has been influenced to incur expenditure in the expectation of receiving assistance.

51. In such cases the timing of events that impact on the entity, or the timing of the expenditure being incurred, represent the point, under equity, when the third party can claim a valid expectation on a government, and therefore represent the point when the obligation should be recognized.

52. On the interplay between the “plan to provide assistance” and the “financial plan” or budget constraints the Government works under, it is generally understood that Governments cannot incur expenses without authority. Doing so would be unconstitutional, and such expenditure is illegal. Therefore, the Government should not accept a claim unless:

- There is sufficient appropriation authority to accept the obligation in the baseline for the relevant Vote
- Authority has been provided under imprest supply and Cabinet has agreed to incur further costs under supplementary appropriations; or
- The expenditure is authorized under a permanent legislative authority

53. This need for appropriate authority is differentiated from the obligations that arise from a contract or that are otherwise legally actionable (refer the Bardolph Case earlier). In those cases the fact of the contract, legislation or deed means that the third party is entitled to rely on the Crown's commitments. In the absence of such instruments, in the absence of budgetary provision, and recognising that Government policy is subject to change, the third party can be expected to temper their reliance on such commitment.

54. To the extent that the government has advised third parties that a claim (even if in accord with policy) is dependent on future budget–baseline management decisions, this will affect the nature of the expectation of third parties as to their rights to receive cash or goods and services. Under such circumstances the Government is able to avoid settling claims and a provision should not be made. However, if third parties know that their claims are not subject to such processes, (e.g. there is permanent legislative authority or the item is considered a demand-driven item for baseline management purposes) then third parties will be entitled to place greater reliance on the expectations created by the government and to act accordingly. Therefore, an additional criteria is that the obligation has not been expressed as subject to future budget decisions. In making a judgement on this criteria it is

important to recognize that inclusion in baseline forecasts does not preclude obligations being subject to future budget decisions.

55. Putting these criteria together results in the following:

56. Criteria to be used for determining when a present obligation arises pursuant to a (non-legislated) policy of the Government:

- the government has a detailed formal policy identifying at least:
 - i) who will provide the assistance;
 - ii) what events qualify for assistance;
 - iii) the types and approximate number of entities who will receive assistance;
 - iv) the amount of expenditures that will be undertaken can be measured reliably; and
 - v) when the assistance will be provided; and
- the government has raised a valid expectation in those affected that it will provide cash or the delivery of goods or services because:
 - i) individuals and entities exist who satisfy the eligibility criteria;
 - ii) the commitment has not been expressed as being subject to future budget decisions, and
 - iii) either the substantial events satisfying the criteria covered by the policy have occurred, or the entity has as a result of that expectation has been influenced to incur expenditure, or acted in the expectation of receiving assistance.

Summary of guidance

Criteria to use in determining if an expected reimbursement is sufficiently certain and sufficiently integrated with the expense to avoid recognising an expense:

- There are effective mechanisms to ensure expenditure will not be incurred without the revenue being levied; and
- There are effective mechanisms to prevent revenue levied being used for other activities; and
- There are past practices of applying the revenue to the expense; and
- The expectations of those paying for the expense are such that they recognise that they bear the risks associated with changing obligations, rather than the Crown.

Criteria to be used for determining when an obligating event leads to a present obligation arising pursuant to an exchange contract

- Specific accounting standards should be followed where applicable. Such standards include: NZ IFRS 4 (PBE IFRS 4) for insurance contracts, NZ IAS 39 (PBE IPSAS 30) for financial instrument contracts, NZ IFRS 3 (PBE IFRS 3) for entity acquisitions, NZ IAS 17 (PBE IPSAS 11) for lease contracts and NZ IAS 37 (PBE IPSAS 19) for Warranties.
- In the absence of a specific accounting standard, the performance of other parties to the contract will be the obligating event that leads to a present obligation.

Criteria to be used for determining when a present obligation arises pursuant to legislation, deed of settlement or deed of agreement:

Where individuals or entities have the right to take legal action against the government to obtain payment of non-reciprocal cash transfers or delivery of goods and services, the criteria to be used for determining if a present obligation (legal) exists are:

- an event meeting the criteria in the legislation or deed has occurred; and
- individuals or entities satisfying the criteria to receive the assistance exist; and
- those recipients have no further substantial acts to complete before receiving the assistance

Criteria to be used for determining when a present obligation arises pursuant to a (non-legislated) policy of the Government:

a) the government has a detailed formal policy identifying at least:

- i) who will provide the assistance;
- ii) what events qualify for assistance;
- iii) the types and approximate number of entities who will receive assistance;
- iv) the amount of expenditures that will be undertaken can be measured reliably; and
- v) when the assistance will be provided; and

b) the government has raised a valid expectation in those affected that it will provide cash or the delivery of goods or services because:

- i) individuals and entities exist who satisfy the eligibility criteria;
- ii) the commitment has not been expressed as being subject to future budget decisions, and
- iii) either the substantial events satisfying the criteria covered by the policy have occurred, or the entity has as a result of that expectation has been influenced to incur expenditure, or acted in the expectation of receiving assistance.

Illustrative examples

Maori Treaty claims

Background

A Treaty settlement is an agreement between the Crown and a Maori claimant group to settle all of that claimant group's historical claims against the Crown.

Claimant groups are usually iwi or large hapu (tribes and sub-tribes) that have a longstanding historical and cultural association with a particular area. Some very specific claims may result in agreements with smaller groups.

Historical claims usually relate to actions or omissions by the Crown in relation to the claimant group. They usually comprise a historical account, acknowledgements and Crown apology, cultural redress, financial and commercial redress, a Deed of Settlement (which usually requires legislation to be fully implemented, and claimant group acceptance that the settlement is fair and final.

The process to reach a settlement usually requires the establishment of a well founded claim, a body being established and obtaining a mandate from the claimant group for negotiations, negotiation between the claimant group and the Crown leading to a deed of settlement being initialled, ratification of the deed of agreement by the full claimant group, and legislation to ensure the finality of the settlement and to implement it.

Application of guidance

Maori Treaty claims involve a non-reimbursable economic sacrifice

On initialling, the future economic sacrifice is not on-going or adjustable

When the deed is initialled, an obligation is reported because:

- an event meeting the criteria in the deed has occurred; and
- individuals or entities satisfying the criteria to receive the assistance exist; and
- those recipients have no further substantial acts to complete before receiving the assistance

Prior to initialling the deed a constructive obligation does not exist because

a) the government has a detailed formal policy is insufficiently formal in identifying at least:

- i) what events qualify for assistance;
- ii) the types and approximate number of entities who will receive assistance;
- iii) the estimated cost; and
- iv) when the assistance will be provided; and

b) therefore the government has not raised a sufficient expectation prior to the deed in those affected that it will provide cash or the delivery of goods or services

Settlement relativity clause

Background

The Deeds of Settlement negotiated with Waikato-Tainui and Ngāi Tahu include a relativity mechanism. The mechanism provides that, where the total redress amount for all historical Treaty settlements exceeds \$1 billion in 1994 present-value terms, the Crown is liable to make payments to maintain the real value of Ngāi Tahu's and Waikato-Tainui's settlements as a proportion of all Treaty settlements. The agreed relativity proportions are 17% for Waikato-Tainui and approximately 16% for Ngāi Tahu.

Application of guidance

There is a non-reimbursable economic sacrifice

The expense is not on-going and adjustable

Possible obligation arises due to legally actionable deed of agreement

The obligation is reported at the point where an event meeting the criteria in the deed (initialing of additional deeds) has occurred. At that point individuals or entities satisfying the criteria to receive the assistance exist; and those recipients have no further substantial acts to complete before receiving the assistance.

Weathertight Homes Financial Assistance Package (FAP)

Background

The FAP offers qualifying homeowners a share of the agreed actual repair cost of repairing leaky homes. The Government and the Territorial Authority (if the Territorial Authority is participating in the FAP) each pay 25% of the agreed repair cost and the homeowner pays the remaining 50%. Under the FAP the homeowner agrees not to sue contributing Territorial Authorities and the government, although homeowners can still pursue other liable parties such as builders, developers and manufacturers of defective products.

The FAP scheme became available to homeowners from 29 July 2011 and eligible homeowners must lodge claims with the Department of Building and Housing prior to 29 July 2016. The 10 year limitation on lodging a weathertight claim means that over time the forecast eligible claims will reduce.

Application of guidance

There is a non-reimbursable economic sacrifice

The expense is not on-going and adjustable

The possible obligation arose due to government policy

At the point the policy was approved and announced:

- a) the government had a detailed formal policy identifying:
 - i) who will provide the assistance;
 - ii) what events qualify for assistance;
 - iii) the types and approximate number of entities who will receive assistance;
 - iv) the estimated cost; and
 - v) when the assistance would be provided; and
- b) the government has raised a valid expectation in those affected that it will provide cash or the
 - i) delivery of goods or services because:
 - ii) individuals and entities existed who satisfy the eligibility criteria;
 - iii) the commitment was not expressed as being subject to budget, and
 - iv) the substantial events satisfying the criteria covered by the policy had occurred

The obligation was therefore reported as a liability at the point the policy was approved and announced

Multi year research grants – dependent on expenses being incurred or milestone achievements.

Background

Some grants will be made on a multi-year basis, but the actual payment of money will be dependent on evidence that expense has been incurred or milestones have been reached. Often, the costs of the grantee are essentially being reimbursed by the grantor.

Application of guidance

There is a non-reimbursable economic sacrifice

The expense is not on-going and adjustable

The possible obligation arises due to government policy

At the point the grant is approved and announced it is clear:

- i) who will provide the assistance;
- ii) what events qualify for assistance;
- iii) the types and approximate number of entities who will receive assistance;
- iv) the estimated cost; and
- v) when the assistance would be provided; and

the government has raised a valid expectation in those affected that it will provide cash or the delivery of goods or services because:

- i) individuals and entities exist who satisfy the eligibility criteria;
- ii) the commitment is not expressed as being subject to future budget decisions,
- iii) BUT the substantial events satisfying the criteria covered by the policy have not occurred

The obligation should therefore not be reported as a liability until the timing or milestone achievements occur.

Multi year research grants – deferred payment, purpose of spending restricted, but no performance or return obligations.

Background

Some grants will be made on a multi-year basis, but the actual payment of money will be deferred, for cash flow management purposes. Nothing beyond the continued existence of the grantee acting within its mandate is required.

Application of guidance

There is a non-reimbursable economic sacrifice

The expense is not on-going and adjustable

The possible obligation arises due to government policy

At the point the grant is approved and announced it is clear:

- i) who will provide the assistance;
- ii) what events qualify for assistance;
- iii) the types and approximate number of entities who will receive assistance;
- iv) the estimated cost; and
- v) when the assistance would be provided; and

and the government has raised a valid expectation in those affected that it will provide cash or the delivery of goods or services because:

- i) individuals and entities exist who satisfy the eligibility criteria;
- ii) the commitment is not expressed as being subject to future budget decisions, and
- iii) no substantial events are required to be satisfied in the future.

The obligation should therefore be reported as a liability at the time the grant is approved and announced.

Offer to Red Zone property owners

Background

Following the disastrous Earthquakes in Canterbury, the Government identified zones of land damage in Christchurch and parts of the Waimakariri district. Land where repair would be prolonged and uneconomic at present was zoned red. As such land is unlikely to be suitable for continued residential occupation for a prolonged period of time, the Government also announced that it was prepared to purchase insured residential property in the red zones on a voluntary basis. There are two options for such purchase of this land:

- The Crown will offer to purchase the property at the most recent rating value for the property (less any insurance payments already made), and will assume all open insurance claims relating to the property other than contents; or
- The Crown will offer to purchase the property at the most recent rating value for the land (less any insurance payments already made on the land), allowing the previous property owner to pursue any open insurance claims relating to the dwelling.

Following a formal offer to residents in the red zone, residents then had nine months to consider the offer of purchase, and to choose either option. Failure to choose an option could mean that residents would forgo the benefits of the offer to them.

Application of guidance

There is a non-reimbursable economic sacrifice

The expense is not on-going and adjustable

The possible obligation arises due to government policy

At the point the offer is approved and announced it is clear:

- i) who will provide the assistance;
- ii) what events qualify for assistance;
- iii) the types and approximate number of entities who will receive assistance;
- iv) what the expected cost was; and
- v) when the assistance would be provided; and

the government has raised a valid expectation in those affected that it will provide cash or the delivery of goods or services because:

- i) individuals and entities exist who satisfy the eligibility criteria;
- ii) the commitment is not expressed as being subject to future budget decisions, and
- iii) and the substantial events satisfying the criteria covered by the policy have occurred

The obligation should therefore be reported as a liability at the point the offer was approved and announced