

Provisions for self-insured liabilities.

by Bob Buchanan

Until recently, there has been some confusion as to the accounting standard applicable to self-insured liabilities. The AASB has determined that the applicable standard is IASB 137, as indicated in the Australian guidance accompanying AASB 137.

- G1. Self-insurance arrangements fall outside the scope of AASB 1023 General Insurance Contracts, as they do not satisfy the definition of an 'insurance contract' which, broadly speaking, is a contract under which one party (the insurer) accepts significant insurance risk from another party (the insured party or policyholder). Accordingly, the treatment of provisions for liabilities arising from self-insurance is determined in accordance with AASB 137 Provisions, Contingent Liabilities and Contingent Assets.*
- G2. Under AASB 137, a self-insurance provision is recognised relating to events occurring prior to the reporting date. Furthermore, like other provisions, a self-insurance liability is measured at the best estimate of the expenditure required to settle the present obligation at the reporting date. Although AASB 137 is the Standard applicable to self-insurance arrangements, some of the principles in AASB 1023 are relevant to determining the best estimate of the self-insurance provision.*
- G3. AASB 1023.6.2 outlines principles for measuring the liability to external parties in respect of expected future payments and is appropriate for measuring a self-insurance provision. Consistent with these principles, a self-insurance provision includes:*
- (a) amounts in relation to unpaid reported claims;*
 - (b) claims incurred but not reported;*
 - (c) claims incurred but not enough reported; and*
 - (d) costs that will be incurred in settling liabilities (which is equivalent to claims handling costs recognised as insurance liabilities).*
- G4. However, the requirements in relation to discount rates and risk margins in AASB 1023 are not applicable to liabilities resulting from self-insurance. The present value of liabilities resulting from self-insurance is determined under AASB 137.*

In accordance with Financial Reporting Council policy, this follows IAS 37. There is a current exposure draft of revisions to IAS37. It is expected that these will be substantially adopted in the next year or two, but this is not certain. If so, under present policy, these changes will flow through to AASB 137.

As it stands, AASB 137 requires provisions for liabilities that fall within its scope, other than contingent liabilities, to be discounted best estimates and that uncertainty be taken into account. The exact import of these requirements is not clear.

Best estimates

The relevant provisions of AASB 137 are as follows.

- 36. *The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the reporting date.***
- 37. *The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the reporting date. However, the estimate of the amount that an entity would***

rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the reporting date.

38. *The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting date.*
39. *Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.*
40. *Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. For example, if an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.*
41. *The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under AASB 112 Income Taxes.*

It is reasonably clear, and this is supported by an example, that this is an expected value although 37 reads more like fair value, which incorporates a market value margin. The issue is clouded, however, by what AASB 137 has to say about risks and uncertainties.

Risks and Uncertainties

The relevant provisions of AASB 137 are as follows.

42. ***The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.***
43. *Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.*

This can be interpreted, consistent with 37, as requiring a margin.

This point is clarified in the exposure draft, which makes it clear that a margin is required but, as this has not progressed beyond the exposure draft stage, it is only an expression of the direction that the IASB is likely to take, not a current accounting requirement.

Discounting

The relevant provisions of AASB 137 are as follows

45. ***Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.***
46. *Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting date are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.*
47. ***The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.***

While this is consistent with the use of a “risk-free” rate, it is not clear that this is what is required. The alternative interpretation is that it allows the use of the expected earning rate on the assets backing the liability. If this view is adopted, it should be noted that the expected earning rate is not the average nominal rate of return on those assets. This should be reduced by an appropriate allowance for the risk of default on those assets.

Again, this point is clarified in the exposure draft, which makes it clear that a “risk-free” rate is required but, as this has not progressed beyond the exposure draft stage, it is only an expression of the direction that the IASB is likely to take, not a current accounting requirement.

Contingent liabilities

AASB 137 includes scope for uncertain liabilities that are unlikely to eventuate to be treated as contingent liabilities. This is unlikely to be applicable to most self-insurance liabilities, but could be relevant if there has been an isolated incident that gives rise to a low probability that there will be a substantial claim.

This concept is eliminated in the exposure draft, which replaces it with the concept of a “stand-ready” obligation. The idea is that, if there are circumstances that may give rise to a valid claim, there is a present obligation to meet any claim that proves valid and this obligation must be recognised. Probability is taken account of in the measurement, rather than as a requirement for registration. As this has not progressed beyond the exposure draft stage, however, it is only an expression of the direction that the IASB is likely to take, not a current accounting requirement.