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feature

CONTINGENT LIABILITIES AND SOLVENCY

Tips for analysing contingent liabilities using a framework incorporating accounting and common law principles.

A critical component within many solvency reports is the treatment of contingent liabilities and the effect these liabilities have on the company's solvency. It is an uncontentious proposition that when preparing a solvency report, financial accounts should be compared to source documents, and if there are discrepancies, the records should be adjusted to reflect the actual position. Regard should also be had to the applicable accounting standards.[1]

When assessing whether a potential contingent liability should be included for the purpose of assessing solvency, an analysis should have regard to:

- The framework published by the Australian Accounting Standards Board (AASB),[2] particularly *AASB 137 Provisions, Contingent Liabilities and Contingent Assets* (AASB 137, or the Standard).
- Case law which assists in the interpretation of the AASB 137 framework and solvency analysis more generally.

DEFINITIONS

For the purpose of this article (and the analysis generally) it is critical to apply standard definitions. We have, where possible, relied on the definitions contained in paragraph 10 of AASB 137 (our defined terms added in square brackets). Including:

> A *provision* is a liability of uncertain timing or amount. [Provision]
>
> …
>
> A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. [Liability]
>
> An *obligating* event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. [Obligating Event]
>
> …
>
> A *legal obligation* is an obligation that derives from:
>
> a) a contract (through its explicit or implicit terms);
> b) legislation; or
> c) other operation of law. [Legal Obligation]
>
> …
>
> A *contingent liability* 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 will be required to settle the obligation; or
>   (ii) the amount of the obligation cannot be measured with sufficient reliability. (Contingent Liability)

Neither the AASB standards nor case law in respect of Contingent Liabilities include a definition of the term 'remote'. The matter is further complicated by the range of terminology used in case law to describe probability. The following standard definitions of 'remote' are relevant for this analysis:

1 The Australian Restructuring Insolvency & Turnaround Association Journal (Volume 34) – "Solvency Reports" by Simon Cathro & Orla McCoy [22-26] March 2022. 2 The AASB is an Australian Government agency under the *Australian Securities and Investments Commission Act 2001*. The statutory functions of the AASB include the making of accounting standards pursuant to s 334 of the *Corporations Act 2001*.

- The U.S. Generally Accepted Accounting Principles (GAAP) requires a company to classify contingent liabilities based on the following definitions:
  as "remote" (meaning the chances that a loss will occur are slight), "probable" (that is, likely to occur) or "reasonably possible" (falling somewhere between remote and probable)
- The Merriam-Webster dictionary defines the term 'remote chance' as "a very small possibility".

THE ANALYSIS

Within the AASB Conceptual Framework there are two relevant sections when undertaking solvency analysis:

1. Recognition
Recognition is the process of capturing the elements of financial statements – an asset, a liability, equity, income or expenses.

2. Measurement
Applying a monetary measurement basis to an asset or liability creates a measure for that asset.
[together, the Conceptual Framework]

The Standard also includes a decision tree in part B of the Guidance on implementing AASB 137 at page 35 (Decision Tree). The Decision Tree (see below) provides a structure to work through the AASB 137 analysis when assessing the appropriate treatment of a potential Contingent Liability, should you:

- provide for the Contingent Liability in the Balance Sheet
- disclose in the notes to the financial statements, or
- do nothing.

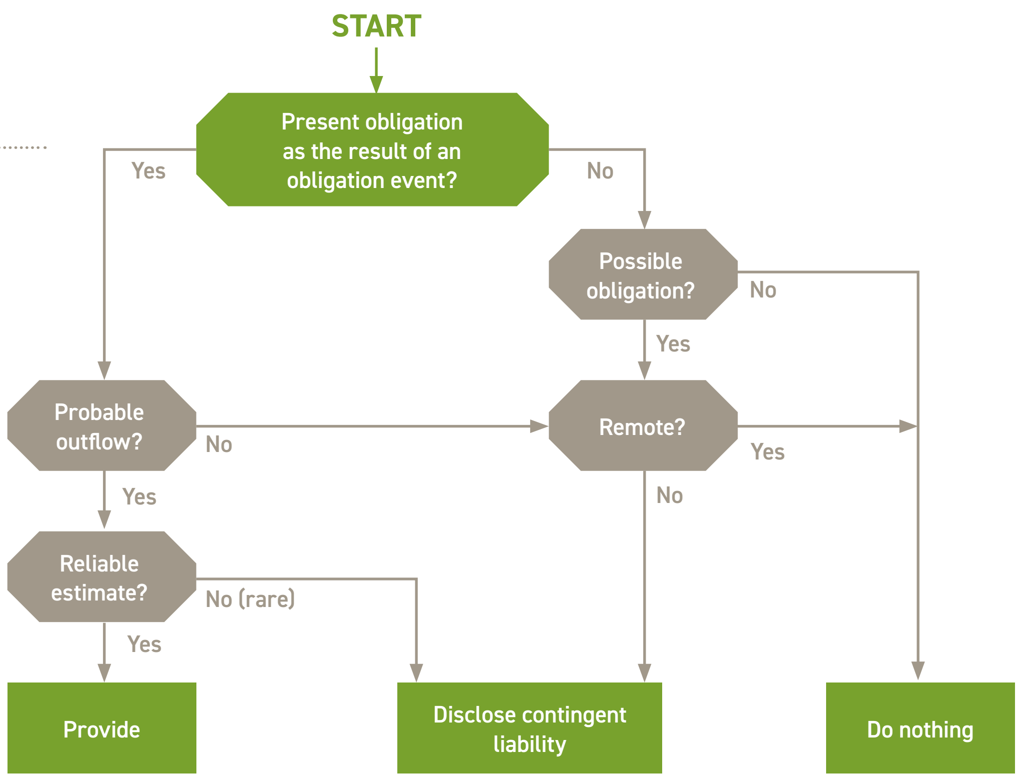
The treatment in the Decision Tree is based on the following questions:

- Does the company have either a:
  - present obligation as the result of an obligating event, or
  - possible obligation?
- Is it probable that an outflow will occur?
- Is the chance of an outflow remote?
- Can a reliable estimate be made of the amount of the obligation?

[Decision Tree Questions]

Where possible we have attempted to group the analysis by either the Conceptual Framework or the Decision Tree Questions.

Decision tree
The purpose of this diagram is to summarise the main recognition requirements of the Standard for provision and contingent liabilities.



Contingent liabilities

THE ACCOUNTING STANDARD (AASB 137)

AASB 137 utilises the above Conceptual Framework when assessing Contingent Liabilities, including:

1. Recognition

Where there is a present Legal Obligation, it is probable there will be an outflow and where a reliable estimate of the obligation can be made in respect of the Contingent Liability, a provision shall be recognised.[3]

The standards do not require that a Contingent Liability be recognised as a liability in the balance sheet.[4] However, where the possible outflows are not remote, a Contingent Liability should be disclosed in the notes as required by paragraph 86.[5]

Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a Contingent Liability. The entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.[6]

2. Measurement

The amount recognised shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.[7]

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 end of the reporting period, or to transfer it to a third party at that time.

The estimates of outcome and financial effect are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts.[8]

Utilising the above Conceptual Framework when assessing a Legal Obligation, it is possible to identify Contingent Liabilities, have a format for their presentation and apply a framework for their measurement.

Critical for the analysis of Contingent Liabilities in accordance with the Standard is a proper definition of the "Probable outflow of resources embodying economic benefits". The Standard defines this as:

> For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard,[9] an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a Contingent Liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86).[10]

THE CASE LAW

The case law is unequivocal in its view that Contingent Liabilities should be taken into account when assessing solvency.[11, 12, 13] Given the sensitivity of any solvency analysis to Contingent Liabilities, an analysis of which Legal Obligation gives rise to a Contingent Liability is critical.

The case law does not limit its analysis to liabilities recognised as provisions. However, it is clear that the analysis predominantly focuses on whether the company has an obligation (or possible obligation),[14, 15, 16] the probability that an outflow will occur[17, 18, 19] (or is remote),[20, 21] when that would occur and the use of hindsight when assessing solvency.[22, 23]

KEY CONSIDERATIONS WITH REFERENCE TO CASE LAW AND AASB WHEN ASSESSING CONTINGENT LIABILITIES

When analysing Contingent Liabilities for the purpose of assessing solvency, a combined approach needs to be taken that looks at case law in conjunction with AASB. To assist with this analysis the below table maps the AASB Standards to the Decision Tree Questions which have been used for the case law analysis.

3 AASB 137 – para 14. **4** AASB 137 – para 27. **5** AASB 137 – para 28. **6** AASB 137 – para 29. **7** AASB 137 – para 36. **8** AASB 137 – para 38. **9** The interpretation of 'probable' in this Standard as 'more likely than not' does not necessarily apply in other AASB standards. **10** AASB 137 – para 23. **11** *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR 176 at [77]. **12** Marshall J in *McBain v Palffy* [2009] FCA 260 at [16]. **13** *Edwards v Attorney-General* (NSW) (2004) 60 NSWLR 667; 50 ACSR 122 at [60]. **14** *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR at [81]. **15** *McBain v Palffy* at [16, 20]. **16** *Anchorage Capital Master Offshore Ltd v Sparkes (No.3); Bank of Communications Co Ltd v Sparkes (No.2)* [2021] NSWSC 1025 at [259, 261]. **17** *Brooks v Heritage Hotel Adelaide Pty Ltd* (1996) 20 ASCR 61 at [65]. **18** *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* at [459]. **19** *Anchorage Capital Master Offshore Ltd v Sparkes (No.3); Bank of Communications Co Ltd v Sparkes (No.2)* at [262]. **20** *McBain v Palffy* at [18]. **21** *Edwards v Attorney-General (NSW)* (2004) at [60]. **22** *Anchorage Capital Master Offshore Ltd v Sparkes (No3.); Bank of Communications Co Ltd v Sparkes (No.2)* at [262]. **23** *Bell Group Ltd (in liq) v Westpac Banking Corp (No.9)* (2008) 39 WAR 1; [2008] WASC 239 at [1116 - 1119].

Decision Tree Questions	Accounting Standard
Does the company have either a: • present obligation as the result of an Obligating Event, or • possible obligation?	AASB 137 – Recognition [para 14–35]
Is it probable that an outflow will occur?	AASB 137 – Recognition [para 14–35]
The chance of an outflow is remote	AASB 137 – Recognition [para 28]
A reliable estimate can be made of the amount of the obligation	AASB 137 – Measurement [para 36–52]

In completing this analysis with the benefit of the Decision Tree, the following key considerations need to be taken into account when answering each question.

Decision Tree Questions	Key Considerations
Does the company have a present obligation as the result of an Obligating Event?	Definition of: An *obligating event* is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. A *legal obligation* is an obligation that derives from: – a contract (through its explicit or implicit terms) – legislation, or – other operation of law.[24]
Does the company have a possible obligation?	The essential feature of a contingent debt or claim is its source in some existing obligation or state of affairs that may or may not mature into a present debt.[25]
Is it probable that an outflow will occur?	A contingent debt exists if there is an existing obligation from which a liability on the part of the debtor to pay a sum of money may arise in a future event, whether it be an event that must happen or only an event that may happen.[26] The court can have regard to what actually happened to the extent that what actually happened sheds light on what was likely at the time when the question of solvency is to be assessed.[27]
Is the chance of an outflow remote?	When assessing whether the chance that an Obligation Event will occur is remote, it is critical to consider the generally accepted meaning of 'remote'. However, the definition contained in GAAP standards and the broader analysis above may be of assistance. The courts have held that prospective liabilities may be ignored if they are "purely speculative and without any real likelihood of being established".[28]
Can a reliable estimate be made of the amount of the obligation?	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 end of the reporting period, or to transfer it to a third party at that time.[29] Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a Contingent Liability. The entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable.[30] The court can apply its knowledge of post-event facts to determine whether the proffered expectations of the parties (the commercial realities with regard to cash flow) were or were not realistic.[31]

CONCLUSION

When dealing with Contingent Liabilities for the purpose of assessing solvency, a combined approach utilising the AASB framework and then overlaying the relevant case law provides experts with clearly structured analysis to identify which Legal Obligations should be included as Contingent Liabilities and which should be excluded.

The AASB framework also provides a repeatable and easy to understand approach for the analysis of Contingent Liabilities as required by the relevant Expert Witness Codes of Conduct. This approach is consistent with the requirements of s 5.6(m) of APES 215 Forensic Accounting Services.

The utilisation of the Decision Tree, incorporating the requirements of the Standard, along with case law provides experts with an easy to follow and repeatable analysis of potential Contingent Liabilities.

Finally, a consistent and measurable approach needs to be taken when describing the probability of an event occurring or not occurring. Hopefully this article will go some way in more clearly defining the terms used in these cases.

24 AASB 137 – para 10. **25** *McDonald v Deputy Commissioner of Taxation* [2005] NSWSC 2 at [40]. **26** *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008). **27** *Anchorage Capital Master Offshore Ltd v Sparkes (No.3); Bank of Communications Co Ltd v Sparkes (No.2)* at [262], Ball J. **28** *McBain v Palffy* at [18]. **29** AASB 137 – para 36. **30** AASB 137 – para 29. **31** *Bell Group Ltd (in liq) v Westpac Banking Corp (No.9)* at [1117].