10A. Provisions, contingent liabilities and contingent assets and funding commitments

10A.1 The reporting tiers applied for Module 10A are as specified in the table below.

Table 10A.1: Tiered reporting for module 10A

All tiers	The requirements for provisions, contingent liabilities and contingent assets and funding commitments in this module apply fully to all charities.

10A.2 Charities should refer to Section 21 *Provisions and Contingencies* of FRS 102 for more information on the recognition and measurement (both initial and subsequent) of provisions and contingent liabilities and assets including the relevant disclosure requirements. Charities should also refer to Appendix A and paragraphs 34.57 to 34.63 of FRS 102 on the treatment of funding commitments.

10A.3 This module covers:

- Provisions, contingent liabilities and contingent assets
- Recognition and measurement of provisions
- Recognition of a funding commitment as a liability
- Accounting for onerous contracts
- Treatment of commitments not recognised as provisions or liabilities
- Disclosure of provisions and funding commitments
- Disclosure of contingent liabilities and contingent assets
- Prejudicial disclosures

Provisions, contingent liabilities and contingent assets

10A.4 A provision is a liability where the amount and/or timing of its settlement is uncertain.

10A.5 A contingent liability is either a possible but uncertain obligation or a present obligation that is not recognised because:

- a transfer of economic benefit to settle the possible obligation is not considered probable; or
- the amount of the obligation cannot be estimated reliably

10A.6 A contingent asset is a possible asset that arises from a past event but is not recognised in the balance sheet. Its 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 charity. When the existence of the asset is considered virtually certain, it is no longer a contingent asset and must be recognised as an asset.

Recognition and measurement of provisions

10A.7 A provision must be recognised by a charity when:

- there is a present obligation (either legal or constructive) at the reporting date as a result of a past event
- it is probable (i.e. more likely than not) that a transfer of economic benefit, usually in the form of cash, will be required in settlement
- the amount of the settlement can be estimated reliably

10A.8 This module uses the term **liability** in a way that differs in some respects from the definition of a liability in paragraph 10.84 and the Glossary of this SORP, and paragraph 2.38 of FRS 102. For the purposes of this section, when it refers to provisions, a liability is a present obligation of the charity arising from past events, the settlement of which is expected to result in an outflow from the charity of resources embodying economic benefits (for more on initial recognition on provisions see paragraphs 21.4 to 21.6 of FRS 102).

10A.9 A charity must initially measure a provision at the best estimate of the amount required to settle the obligation or to transfer it to a third party at the reporting date. When calculating this amount, consideration must be given to:

- when the payments are likely to be made
- future events and uncertainties which may affect the amount required to settle the obligation

10A.10 Where the effect of the time value of money is material, the present value (i.e. the amount in today's terms) of the provision must be calculated using an appropriate discount rate. If the obligation is likely to be settled within a short period of time, it is less likely that the provision will need to be adjusted for the time value of money.

10A.11 The discount rate used must reflect the cost of money to the charity, its current assessment of the time value of money and the risks specific to the provision. Depending on the charity’s circumstances, the appropriate discount rate may be the market rate of interest at which the charity could borrow over the relevant time period or, if the charity has significant funds invested, the opportunity cost of income from investments foregone (for more on initial measurement of provisions see paragraphs 21.7 to 21.9 of FRS 102).

10A.12 Where provisions are discounted to present value, the discount must be ‘unwound’ at the discount rate in subsequent reporting periods. The unwinding of the discount must be treated as a financing cost in the statement of financial activities (SoFA). It must be allocated to the appropriate expense line item. For example, the unwinding of a discount resulting from a grant liability must be allocated to expenses incurred on charitable activities.

10A.13 Following initial recognition a charity must review the best estimate of a provision at each reporting date and adjust it to reflect the current best estimate of the settlement amount.

10A.14 A charity must review the likelihood of settlement of a provision at each reporting date following initial recognition. If a transfer of resources to settle the obligation is no longer considered probable, the obligation should no longer be recognised as a liability and must be reversed in the balance sheet. This will require a corresponding credit to the expense line item in the SoFA against which the provision was originally charged.

Recognition of a funding commitment as a liability

10A.15 The award of a grant is a non-exchange transaction. The decision to award a grant may create a funding commitment. This is recognised as a liability with a corresponding expense only when the definition and recognition criteria for a liability have been satisfied and:

- the criteria for an obligation (either legal or constructive) are met
- payment is probable
- the liability can be measured reliably
- there are no performance-related conditions attaching to its payment that limit its recognition. For more information on funding commitments see paragraphs 34.57 to 34.63 and Appendix A to Section 34 of FRS 102 and module 7 of this SORP

10A.16 Where a grant is payable over a period of more than one year, payments for later years may be subject to performance-related conditions and the donor charity may be able to legitimately withdraw from its commitment (if, for example, a particular condition attaching to the grant is not met). In this situation, the recognition of a liability is not required.

10A.17 Funding commitments can be made that give the funder the discretion to avoid future expenses based on their assessment of whether the performance-related conditions attached to the commitment will be met by the recipient. Where the donor charity retains the discretion to avoid the expense, a liability must not be recognised. For example, where a commitment is made to provide grant funding over a number of years, future payments may be subject to a review by the donor charity which gives it discretion to terminate the funding agreement. Provided the performance-related condition and review process has been communicated to the recipient as part of the funding agreement and the review process has substance (i.e. the review has a potential impact on future payments), then the criteria for recognition of a liability are unlikely to be met.

10A.18 Alternatively, when there is no performance-related condition attached to the grant that allows the donor charity to realistically avoid the commitment, a liability for the full funding obligation must be recognised. Where the time value of money is material, the amount recognised as a liability must be discounted to present value.

10A.19 Not all terms attaching to a funding commitment create a situation that gives a donor charity discretion to withdraw from its funding obligation. For example, a term in a grant offer might relieve the donor charity from a future obligation in the event of a lack of funds at a future settlement date. Such a term does not allow the charity to withdraw from the funding commitment at the charity's discretion, therefore would not normally prevent the recognition of a liability and a corresponding expense (assuming payment of the grant is probable). The liability would only be derecognised (removed from the balance sheet) if a future event required the funding offer to be rescinded. Where a provision has been previously recognised, its removal (derecognition) must be made in the SoFA and deducted from the line item to which the expense was originally charged.

10A.20 Grant commitments may contain conditions that are outside the control of the donor charity. For example, a charity may promise a grant payment on the condition that the recipient finds matching funding. When a condition falls outside the control of the donor charity, a liability arises and expenditure must be recognised if the payment of the grant is probable.

Treatment of funding commitments not recognised as provisions or liabilities

10A.21 Not all funding commitments are recognised as liabilities or provisions. For example, where a grant offer is made, but there is uncertainty as to whether the recipient will be able to proceed with its proposal.

10A.22 If payment of a funding commitment is considered possible but not probable, a liability for the commitment must not be recognised. Instead, the funding commitment must be disclosed as a contingent liability. This requirement applies to funding commitments entered into within the current reporting period and to existing funding commitments for which payment was considered probable in a previous reporting period, but is considered possible rather than probable at the end of the current reporting period. Where this occurs the liability that was recognised in the previous reporting period should be removed (derecognised) from the balance sheet in the current reporting period.

10A.23 It is important that charities disclose the existence of unrecognised commitments and explain how these will be funded.

10A.24 A charity may intend to use unrestricted funds held at the reporting date to meet a funding commitment and may decide to designate a portion of unrestricted funds for this purpose. This SORP permits the use of a designation in the notes to the accounts to identify that portion of unrestricted funds that have been set aside to meet the commitments. However, where activities are to be wholly financed from future income, existing unrestricted funds must not be designated for the purpose of financing such activities.

Accounting for onerous contracts

10A.25 Situations may arise where the unavoidable costs of fulfilling a contract exceed the expected economic benefit derived from it. Such a contract would be considered an onerous contract.

10A.26 If a charity has a contract that is onerous, the charity recognises and measures the present obligation under the contract as a provision. The unavoidable costs are the least net cost of exiting the contract, being the lower of:

- the cost of fulfilling it
- any compensation or penalties arising from failure to fulfil it, offset against any economic benefit that is derived from the contract

The cost of fulfilling a contract comprises the incremental costs of fulfilling that contract and an allocation of other costs that relate directly to fulfilling it.

10A.27 Routine purchase orders and contracts which can be cancelled by agreement without paying compensation should not be regarded as onerous. However, a charity must make a provision for a material loss-making contract which cannot be cancelled without the payment of compensation. If a charity identifies a contract as onerous, it must make an immediate provision for the unavoidable costs.

10A.28 A charity may choose to provide a level of service to its beneficiaries over and above the minimum requirements of a contract as part of its charitable activities. Any additional costs incurred in providing a level of service above contractual requirements do not create an onerous contract even when these costs cannot be recovered. Costs that are incurred on a discretionary basis from which the charity can withdraw should be excluded from any assessment of whether a contract is onerous.

10A.29 Before calculating the provision for an onerous contract, the charity must undertake an impairment review of the fixed assets used in supplying the contracted service(s). For more information refer to the SORP module 12 ‘Impairment of assets’.

10A.30 A contract entered into on a full cost recovery or ‘cost plus margin’ basis is only likely to become onerous if unavoidable costs arise in meeting the contract that cannot be recovered under the terms of the contract.

Disclosure of provisions and funding commitments

10A.31 Charities must include a separate line item for provisions in the balance sheet (see paragraph 10.86 of this SORP).

10A.32 All charities must analyse the expenses resulting from provisions and recognised funding commitments across the appropriate lines(s) in the SoFA and disclose in the notes to the accounts:

(a) a reconciliation of the movements in provisions and funding commitments showing:

  i. the carrying amount at the beginning of the reporting period
  ii. additions during the reporting period, including adjustments that result from changes in measuring the discounted amount
  iii. amounts charged against the provision during the reporting period
  iv. unused amounts reversed during the reporting period
  v. the carrying amount at the end of the reporting period

(b) a brief description of the nature of the provision or commitment made and the expected amount and timing of any resulting payments

(c) an indication of the uncertainties about the amount or timing of those payments, including any performance-related conditions attached to recognised funding commitments

(d) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement

Comparative information for prior periods is not required.

10A.33 For any funding commitment that is not recognised as a liability or provision, charities must disclose:

- details of the commitment made

- the time frame of that commitment
- any performance-related conditions attached to that commitment
- details on the sources of funding for how the commitment will be funded

10A.34 This SORP requires that if unrestricted funds have been designated to fund a commitment, the notes to the accounts must disclose:

- the nature of any amounts designated
- if not explained in the trustees' annual report, the likely timing of any payments

Disclosure of contingent liabilities and contingent assets

10A.35 Contingent liabilities must be disclosed unless the possibility of their existence is remote. Contingent assets must be disclosed when their existence is probable.

10A.36 The notes to the accounts must provide for each class of item:

- a brief description of each contingent item; and
- where practicable, an estimate of its financial effect

10A.37 Charities must, where practicable, also provide:

- an indication of the uncertainties relating to the amount or timing of settlement
- the possibility of any reimbursement

10A.38 If it is impracticable to make one or more of the disclosures in paragraph 10A.37, that fact must be stated

Prejudicial disclosures

10A.39 In extremely rare cases, disclosure of some or all of the information required by paragraphs 10A.31 to 10A.37 can be expected to prejudice seriously the position of the charity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such circumstances, charities must refer to paragraph 21.17 of FRS 102 for disclosure requirements.