Exposure Draft

ED 140
July 2005

Proposed Amendments to AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 119 *Employee Benefits*

Prepared by the
Australian Accounting Standards Board

Australian Government

Australian Accounting Standards Board

Commenting on this Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 23 September 2005. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 28 October 2005. Comments should be addressed to:

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A copy of all non-confidential submissions to the AASB will be placed on public record on the AASB's website: www.aasb.com.au.

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AASB's website: www.aasb.com.au. Alternatively, printed copies of this Exposure Draft are available by contacting:

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The IASB ED comprises a clean copy of IAS 37 and a marked up copy of IAS 19, including Bases for Conclusions and Illustrative Examples. A mark-up of the proposed changes to IAS 37 is available on the AASB website (www.aasb.com.au). The AASB intends to retain the application and materiality paragraphs (as per the existing AASB 137) in the revised AASB 137. The AASB also intends to review the Australian Guidance on self-insurance arrangements and captive insurers that accompanies the existing AASB 137 in light of the proposed amendments.

PREFACE

Background

Australian Accounting Standards

The Australian Accounting Standards Board (AASB) makes Australian Accounting Standards to be applied by:

(a) entities required by the *Corporation Act 2001* to prepare financial reports;

(b) all reporting entities engaged in either for-profit, not-for-profit or public sectors; and

(c) any other entity that prepares general purpose financial reports.

Australian Accounting Standards that apply to annual reporting periods beginning on or after 1 January 2005 include Australian equivalents to International Financial Reporting Standards (IFRSs). IFRSs comprise accounting standards and interpretations. IFRSs are issued by the International Accounting Standards Board (IASB), and their adoption in Australia is in accordance with a strategic directive made by the Financial Reporting Council. The reasons for adoption of IFRSs in Australia are explained in CLERP Paper No. 9: *Proposals for Reform – Corporate Disclosure* (2002).

Although IFRSs are developed to apply to for-profit entities, the AASB has decided to continue to make sector-neutral accounting standards. Accordingly, Australian Accounting Standards (including Australian equivalents to IFRSs) generally apply to both for-profit and not-for-profit entities, including public sector entities. An Australian equivalent to an IFRS uses the corresponding IFRS as the "foundation" Standard to which the AASB adds material detailing its scope and applicability in the Australian environment. Additions are made, where necessary, to broaden the content of the Australian equivalent to an IFRS to cover domestic, regulatory or other issues. In addition to making accounting standards that are Australian equivalents to IFRSs, the AASB also continues to make other Australian Accounting Standards that are specific to the not-for-profit or public sectors or that are purely of a domestic nature.

Exposure Drafts

The adoption of IFRSs is an ongoing process. Whenever the IASB issues new or amended IFRSs, the AASB must also consider making new or amended Australian equivalents to those IFRSs.

In developing a new or amended IFRS, the IASB releases an Exposure Draft (ED) of the proposed Standard or amendments for public comment. The AASB generally follows a similar due process prior to making or amending Australian Accounting Standards. In the case of changes proposed by the IASB to IFRSs, the AASB also releases an ED containing those proposed changes and specifically invites comments from Australian constituents on, among other things, whether the implementation of the proposals in an Australian equivalent to an IFRS may be affected by the Australian environment (including the legal and regulatory environment) and whether the proposals are in the best interests of the Australian economy.

Purpose of this Exposure Draft

The purpose of this ED is to invite comments from Australian constituents on proposed amendments to AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 119 *Employee Benefits*, which are the Australian equivalents to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*.

These proposed amendments are contained in the *Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee*

Benefits that was issued by the IASB on 30 June 2005. If these amendments are approved by the IASB, and subsequently by the AASB, they are expected to be applicable to annual reporting periods beginning on or after 1 January 2007.

Structure of this Exposure Draft

The AASB has decided to:

(a) reproduce the IASB *Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* without amendment as part of this ED; and

(b) identify the main changes and the AASB's preliminary views in this Preface.

To assist constituents in their assessment of the proposed amendments, this Preface provides comparative information and explanations, arranged in the following order.

Application (*application date, application and materiality paragraphs, implications for public sector entities*)

Summary of Main Changes to AASB 137

Summary of Main Changes to AASB 119

Request for Comments (*including specific matters*)

A copy of all Australian Accounting Standards applicable to annual reporting periods beginning on or after 1 January 2005, including the existing AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 119 *Employee Benefits*, may be downloaded free of charge from the AASB website (www.aasb.com.au).

Application

The proposals in the ED are intended to:

(a) replace AASB 137, issued in July 2004;

(b) amend some of the requirements of AASB 119:

  (i) first issued in July 2004, with application to reporting periods beginning on or after 1 January 2005; or

  (ii) subsequently revised in December 2004, with application to reporting periods beginning on or after 1 January 2006 (unless early adopted); and

(c) consequentially amend a number of other Australian Accounting Standards. This ED identifies the consequential amendments to various Australian equivalents to IFRSs. The AASB is currently reviewing the consequential amendments that would need to be made to domestic Australian Accounting Standards (including Interpretations of the Urgent Issues Group). Constituents will be advised of these consequential amendments separately.

The existing requirements of these Standards remain operative until superseded by the proposals in this ED.

Application Date

The AASB intends to make the revised AASB 137 and the amendments to AASB 119 and other Standards applicable from the start of the first annual reporting period beginning on or after 1 January 2007. Earlier application is proposed to be permitted for annual reporting periods beginning on or after the date the amendments are made by the AASB.

The restatement of comparative information when the amendments are first applied is not being proposed.

Application and Materiality Paragraphs

The AASB intends to include the application and materiality paragraphs (as per the existing AASB 137) in the revised AASB 137.

For the amendments to AASB 119 and other Australian Accounting Standards, the application and materiality paragraphs in those Standards will continue to apply.

Implications for Public Sector Entities

No additional requirements or exemptions were included in the existing AASB 137 for either not-for-profit or public sector entities. Although for certain public sector entities, some guidance on the recognition of obligations to provide non-exchange social benefits is provided in other Australian Accounting Standards (see, specifically, AAS 31 *Financial Reporting by Governments* (paragraph 12.1.2) and AAS 29 *Financial Reporting by Government Departments* (paragraph 8.1.4), and more generally AAS 27 *Financial Reporting by Local Governments*). As the AASB has recently decided to propose the withdrawal of AAS 27, AAS 29 and AAS 31 (refer AASB *Action Alert*, July 2005), the AASB will consider whether the specific guidance should be added to a revised AASB 137. In the longer term, it is anticipated that the AASB will revisit the accounting treatment of non-exchange social benefits following the outcomes of the work that the International Public Sector Accounting Standards Board is currently undertaking on social policy obligations.

Summary of Main Changes to AASB 137

A summary of the main changes to AASB 137 and the AASB's preliminary views on these changes follows. Refer to the IASB ED, pages 14 to 18, for a summary of the main changes to IAS 37.

Scope of AASB 137

AASB 137 defines a provision as a 'liability of uncertain timing or amount'. The ED does not use 'provision' as a defined term and instead proposes using the term 'non-financial liability' which includes items previously described as provisions as well as other non-financial liabilities. The purpose of this proposed amendment is to clarify that AASB 137, except in specified cases, should be applied to all non-financial liabilities that are not within the scope of other Australian Accounting Standards. A consequence of this amendment and the amendments to contingent liabilities and contingent assets (as explained below) is that the title of AASB 137 is proposed to change to AASB 137 *Non-financial Liabilities.*

AASB preliminary view: The AASB supports these proposed changes.

Contingent Liabilities

AASB 137 defines a contingent liability as a possible obligation or as a present obligation that is not recognised. (A contingent liability that is a present obligation is not recognised either because it is not probable that an outflow of resources will be required to settle the obligation or because the amount of the obligation cannot be measured reliably.) AASB 137 does not permit contingent liabilities to be recognised but requires their disclosure, unless the possibility of any outflow of economic resources in settlement of the contingent liability is remote. The ED:

(a) proposes eliminating the term 'contingent liability';

(b) uses the term 'contingency' to refer to uncertainty about the amount that will be required to settle a liability rather than uncertainty about whether a liability exists; and

(c) specifies that in the case of a liability where the amount required to settle the liability is contingent on one or more uncertain future events, the liability is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur).

The purpose of these proposed amendments is to:

(a) clarify that only present obligations (rather than possible obligations) of an entity give rise to liabilities and that liabilities arise from unconditional obligations; and

(b) require uncertainty about future events that affect the amount that will be required to settle a liability to be reflected in the measurement of the liability.

AASB preliminary view: The AASB supports these proposed changes.

Contingent Assets

AASB 137 defines a contingent asset as a possible asset. It does not permit contingent assets to be recognised but requires them to be disclosed if an inflow of economic benefits is probable. The ED:

(a) proposes eliminating the term 'contingent asset';

(b) uses the term 'contingency' to refer to uncertainty about the amount of the future economic benefits embodied in an asset rather than uncertainty about whether an asset exists; and

(c) proposes that items formerly described as contingent assets may be within the scope of IAS 38 *Intangible Assets* rather than IAS 37.

The purpose of the proposed amendment is to clarify that only resources controlled by the entity as a result of a past transaction or event (rather than possible assets) give rise to assets and that assets arise from unconditional rights.

AASB preliminary view: The AASB supports these proposed changes.

Constructive Obligations

AASB 137 defines a constructive obligation as an obligation that derives from an entity's actions when the entity has indicated to other parties that it will accept particular responsibilities and, as a result, has created a valid expectation on the part of those other parties that it will discharge those responsibilities. The ED proposes to:

(a) amend the definition of a 'constructive obligation' to clarify that the actions of an entity must result in other parties having a valid expectation that they can 'reasonably rely' on the entity to discharge its responsibilities; and

(b) give additional guidance on determining whether an entity has incurred a constructive obligation.

AASB preliminary view: The AASB supports these proposed changes, but is concerned that the proposed commentary in paragraph 15 on the existence of constructive obligations does not clearly identify that the ED aims to restrict the scope of constructive obligations as defined and understood in the current version of IAS 37. This may, in part, be attributable to the fact that it is difficult to foresee many circumstances when an entity can create a valid expectation in a counterparty that it will accept particular responsibilities even though the counterparty is unable to justify that it can reasonably rely on the entity to discharge its

responsibilities. In other words, if a counterparty cannot reasonably rely on the entity's undertaking, then it would appear difficult to argue that a valid expectation has been created. Paragraphs BC54-BC60 of the IASB Basis for Conclusions confirm that the IASB's intent is to restrict the circumstances in which a constructive obligation can exist, however this is not readily apparent from the ED or, more importantly, from the proposed revisions to the definition of a constructive obligation.

Probability Recognition Criterion

AASB 137 requires provisions to be recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the provision. In some cases, the examples accompanying AASB 137 apply this probability recognition criterion to what the ED identifies as conditional obligations. For example, in the case of a product warranty, AASB 137 explains that the entity considers the likelihood of claims arising under the warranty. In effect, this means that the entity considers whether it is probable that the conditional obligation will result in an outflow of resources embodying economic benefits. Consistent with the revised analysis of contingent liabilities, the IASB Basis for Conclusions explains that the probable outflow criterion should always be applied to the liability (that is, unconditional obligation). Therefore, if an entity has a non-financial liability arising from an unconditional obligation that is accompanied by a conditional obligation, the criterion is applied to the unconditional obligation rather than the conditional obligation. In the product warranty case, the criterion should be applied to the unconditional obligation to stand ready to honour warranty claims (that is, to provide warranty coverage). As a result, the IASB Basis for Conclusions highlights that the probability recognition criterion is always satisfied in relation to the unconditional obligation and therefore the ED proposes omitting the criterion from AASB 137.

AASB preliminary view: The AASB is still considering this issue, but it has some concerns as to whether this is the best approach. Omitting the probability recognition criterion may be appropriate in the context of IAS 37 given the proposed changes to IFRS 3 Business Combinations (as outlined in ED 139 Proposed Amendments to AASB 3 Business Combinations), but may also give rise to difficulties in other Standards. An analysis of the issue at the Framework level would help to reveal all of the implications of omitting the probability recognition criterion for liabilities and assets.

Measurement

AASB 137 requires provisions to be measured at the best estimate of the expenditure required to settle the present obligation at the reporting date. The best estimate is described as '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'. Although expected value is used as the basis of measuring a provision involving a large population of items, AASB 137 states that the best estimate of single obligations may be the 'individual most likely outcome'. The ED:

(a) proposes that a non-financial liability be measured at the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party at reporting date;

(b) emphasises that expected value can be used as the basis for measuring a non-financial liability for both a class of similar obligations and a single obligation; and

(c) explains that measuring a non-financial liability for a single obligation at its most likely outcome would not necessarily be consistent with AASB 137's measurement objective.

AASB preliminary view: As a general principle, the AASB does not support the introduction or maintenance of optional treatments in accounting standards. As such, it is concerned that proposed paragraph 29 contemplates two different measurement bases for the measurement of a non-financial liability, and does not identify which measure is preferred or should take precedence. One measurement basis is entity-specific (the amount that the entity would

rationally pay to settle the present obligation on the balance sheet date); the other is market determined (the amount that the entity would rationally pay to transfer it to a third party on that date). The market determined measure would be expected to give rise to a larger liability amount, as the market would generally seek a premium for assuming the liability of another entity as compensation for being less familiar with the risks attached to the liability. Although this issue exists in the current version of IAS 37, it is more prominent in the revisions due to the proposed deletion of the 'best estimate' measurement concept. Retaining the two options is not consistent with paragraph 13 of the IASB Preface to International Financial Reporting Standards and has the potential to reduce the comparability of the financial statements of different entities.

Reimbursement

When expenditure required to settle a provision is expected to be reimbursed by another party, AASB 137 requires the reimbursement to be recognised when it is virtually certain that the reimbursement will be received. Consistent with the revised analysis of a contingent asset, the ED proposes that, if an entity has a right to receive reimbursement, that right be recognised as an asset if it can be measured reliably.

AASB preliminary view: The AASB supports this proposed change.

Onerous Contracts

AASB 137 defines an onerous contract as one in which the unavoidable costs of meeting its obligations exceed the economic benefits expected. The entity recognises as a provision the present obligation under the contract. AASB 137 provides no further guidance about when the provision should be recognised. The ED proposes:

(a) additional recognition guidance to specify that, when a contract becomes onerous as a result of an entity's own action, the liability is not recognised until the entity has taken that action; and

(b) to specifying that, in the case of an onerous operating lease, the unavoidable costs of meeting the obligation are based on the unavoidable lease commitment less any sublease rentals that the entity could reasonably obtain for the property regardless of whether the entity intends to sublease the property.

AASB preliminary view: The AASB supports these proposed changes.

Restructuring Provisions

AASB 137 states that an entity has a constructive obligation for restructuring when it has a detailed formal plan for restructuring and has raised a valid expectation in those affected that it will carry out the restructuring has a constructive obligation. Therefore it recognises a provision for the direct expenditures arising from the restructuring. The ED proposes:

(a) revising the application guidance for restructuring provisions to specify that a non-financial liability for a cost associated with a restructuring is recognised only when the definition of a liability has been satisfied for that cost. Accordingly, a cost associated with a restructuring is recognised as a liability on the same basis as if that cost arose independently of a restructuring; and

(b) specific guidance for treating costs that are often incurred in a restructuring as follows:

    (i) the cost of employee termination benefits is recognised in accordance with AASB 119 *Employee Benefits*;

    (ii) a liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity is recognised when the entity ceases using the right conveyed by the contract (in addition to any

liability recognised if the contract was previously determined to be onerous); and

(iii) the cost of terminating a contract before the end of its term is recognised when the entity terminates the contract, in accordance with the contract terms.

AASB preliminary view: The AASB is concerned that the proposed general guidance in respect of the existence of constructive obligations may not always be consistent with the specific guidance on constructive obligations arising from restructuring arrangements.

Summary of Main Changes to AASB 119

A summary of the main changes to AASB 119 and the AASB's preliminary views on these changes follows. Refer to the IASB ED, page 134, for a summary of the main changes to IAS 19.

Definition of Termination Benefits

The definition of termination benefits in AASB 119 includes employee benefits that are payable as a result of an employee's decision to accept voluntary redundancy in exchange for those benefits. The ED proposes that:

(a) the definition be amended to clarify that benefits payable in exchange for an employee's decision to accept voluntary redundancy are termination benefits only if they are offered for a short period; and

(b) other employee benefits offered to encourage employees to leave service before normal retirement date are post-employment benefits.

AASB preliminary view: The AASB supports these proposed changes.

Recognition

AASB 119 requires termination benefits to be recognised when the entity is demonstrably committed to either terminating the employment of employees before the normal retirement date or providing termination benefits as a result of an offer made in order to encourage voluntary redundancy. The ED proposes that:

(a) voluntary termination benefits be recognised when employees accept the entity's offer of those benefits; and

(b) involuntary termination benefits be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria, unless the involuntary termination benefits are provided in exchange for employees' future services (that is, in substance they are a 'stay bonus'). In such cases, the liability for those benefits is recognised over the future service period.

AASB preliminary view: The AASB supports these proposed changes.

Request for Comments

Comments are invited on any of the proposals in the ED, including the questions on the proposed amendments to IAS 37 and IAS 19 as listed in the Invitation to Comment sections of the IASB ED.

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 23 September 2005. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 28 October 2005. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The

AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Specific Matters for Comment

In addition, the AASB would value comments on:

(a) whether constituents support the Board's preliminary views and/or share the Board's concerns with the proposed amendments;

(b) any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

  (i) not-for-profit entities;

  (ii) public sector entities;

(c) whether the proposals are in the best interests of the Australian economy; and

(d) whether constituents support the removal of the probability threshold for non-financial liabilities accounted for under IAS 37, and if not, whether the removal of the probability threshold is supported for non-financial liabilities assumed in a business combination.

Exposure Draft of Proposed

AMENDMENTS TO

IAS 37
PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

IAS 19
EMPLOYEE BENEFITS

Comments to be received by 28 October 2005

ED 140

This Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as a revised IAS 37 and amendments to IAS 19. Comments on the Exposure Draft and the Bases for Conclusions should be submitted in writing so as to be received by **28 October 2005**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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IASB Exposure Draft June 2005

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INTRODUCTION

1 This Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (to be retitled *Non-financial Liabilities*) and IAS 19 *Employee Benefits* has been published by the International Accounting Standards Board as a result of two of its projects: the Short-term Convergence project and the second phase of the Business Combinations project.

2 The objective of short-term convergence (undertaken jointly with the Financial Accounting Standards Board (FASB) in the United States) is to reduce differences between International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (US GAAP). Short-term convergence focuses on differences that can be resolved in a relatively short time and can be addressed outside current and planned major projects. It is one strand of the Board's broader objective of convergence of accounting standards around the world.

3 One aspect of the joint short-term convergence project involves the two boards considering each other's recent standards with a view to adopting high quality accounting solutions. The proposed amendments to the requirements in IAS 37 for constructive obligations, onerous contracts and restructuring provisions, together with the complementary amendments to the requirements in IAS 19 for termination benefits, result from the IASB's consideration of FASB Statement No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146), issued in 2002. The Board believes that the proposed amendments would both improve accounting and achieve substantial convergence with the recognition requirements of SFAS 146.

4 The second phase of the Business Combinations project is a joint project with the FASB, and involves a broad reconsideration of the requirements in IFRSs and US GAAP on applying the purchase method (now called the 'acquisition method' in the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations*) to the accounting for business combinations. This has included reconsidering the treatment in a business combination of the contingencies of an acquiree. As a consequence, the Board proposes to eliminate the terms 'contingent asset' and 'contingent liability' in IAS 37 (and in other Standards) and to analyse afresh items previously described as such. These proposed amendments have also required a reconsideration of the probability recognition criterion in IAS 37. The Board believes that these amendments achieve substantial convergence with the recognition principles underpinning FASB Interpretations No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* and No. 47 *Accounting for Conditional Asset Retirement Obligations*. Because these amendments were prompted by the second phase of the Business Combinations project, this Exposure Draft is published simultaneously with the Exposure Draft of Proposed Amendments to IFRS 3. If confirmed in a Standard, the proposals in this Exposure Draft would have an effective date of 1 January 2007, the same as is proposed for the revised IFRS 3.

5 In developing this Exposure Draft, the Board has made amendments related to its decisions in the Short-term Convergence project and the second phase of the Business Combinations project. These amendments particularly affect the definitions and the recognition requirements. The Board has not reconsidered all of the requirements in IAS 37 and IAS 19. However, it has taken the opportunity to clarify the scope of IAS 37. As a result, it proposes not to use 'provision' as a defined term but instead to use the term 'non-financial liability'. The Board also proposes to clarify some aspects of the existing measurement requirements.

Invitation to comment

6 The Board invites comments on all the amendments to IAS 37 and IAS 19 proposed in this Exposure Draft and would particularly welcome answers to the questions in the Invitation to Comment. As noted above, the Board is not considering changes to all of the requirements in IAS 37 and IAS 19 at this time. Therefore, the Board is not requesting comments on aspects of those Standards not proposed for change.

7 Comments should be submitted in writing so as to be received no later than **28 October 2005**.

IASB Exposure Draft June 2005

Presentation of the document

8 This Exposure Draft presents for the proposed amendments to each of the two Standards:

- An invitation to comment. Questions have been limited to the main issues, but the Board would also welcome comments on other changes proposed.
- A summary of main changes. This section summarises the Board's proposals for changes to the Standard. Minor matters and editorial changes are not mentioned.
- The revised text presented as (a) a 'clean' draft of the full text of IAS 37 and (b) a marked-up copy of the amended paragraphs of IAS 19.
- A Basis for Conclusions. This section presents the basis for the Board's conclusions on major issues.
- Consequential amendments to other Standards and IFRIC Interpretations.

PROPOSED AMENDMENTS TO

IAS 37
PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

INVITATION TO COMMENT

The Board would particularly welcome answers to the questions below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale, and, when applicable, provide a suggestion for alternative wording.

Question 1 – Scope of IAS 37 and terminology

The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To emphasise this point, the Exposure Draft does not use 'provision' as a defined term to describe liabilities within its scope. Instead, it uses the term 'non-financial liability' (see paragraph 10). However, the Exposure Draft explains that an entity may describe some classes of non-financial liabilities as provisions in their financial statements (see paragraph 9).

(a) Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why?

(b) Do you agree with not using 'provision' as a defined term? If not, why not?

Question 2 – Contingent liabilities

The Exposure Draft proposes to eliminate the term 'contingent liability'.

The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations (see paragraph BC11). Hence, it highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30).

The Basis for Conclusions also explains that many items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because the contingency does not relate to whether an unconditional obligation exists. Rather it relates to one or more uncertain future events that affect the amount that will be required to settle the unconditional obligation (see paragraph BC23).

The Basis for Conclusions highlights that many items previously described as contingent liabilities can be analysed into two obligations: an unconditional obligation and a conditional obligation. The unconditional obligation establishes the liability and the conditional obligation affects the amount that will be required to settle the liability (see paragraph BC24).

The Exposure Draft proposes that when the amount that will be required to settle a liability (unconditional obligation) is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events, the liability is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur). Uncertainty about the future event(s) is reflected in the measurement of the liability recognised (see paragraph 23).

(a) Do you agree with eliminating the term 'contingent liability'? If not, why not?

(b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

Question 3 – Contingent assets

The Exposure Draft proposes to eliminate the term 'contingent asset'.

As with contingent liabilities, the Basis for Conclusions explains that assets arise only from unconditional (or non-contingent) rights (see paragraph BC11). Hence, an asset (an unconditional right) cannot be contingent or conditional, and a right that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to an asset (see paragraph BC17).

The Basis for Conclusions also explains that many items previously described as contingent assets satisfy the definition of an asset in the *Framework*. This is because the contingency does not relate to whether an unconditional right exists. Rather, it relates to one or more uncertain future events that affect the amount of the future economic benefits embodied in the asset (see paragraph BC17).

The Exposure Draft proposes that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38 *Intangible Assets* rather than IAS 37 (except for rights to reimbursement, which remain within the scope of IAS 37). This is because such items are non-monetary assets without physical substance and, subject to meeting the identifiability criterion in IAS 38, are intangible assets (see paragraph A22 in the Appendix). The Exposure Draft does not propose any amendments to the recognition requirements of IAS 38.

(a) Do you agree with eliminating the term 'contingent asset'? If not, why not?

(b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?

Question 4 – Constructive obligations

The Exposure Draft proposes amending the definition of a constructive obligation to emphasise that an entity has a constructive obligation only if its actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform (see paragraph 10). The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation (see paragraph 15).

(a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?

(b) Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided?

Question 5 – Probability recognition criterion

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognised unless they cannot be measured reliably.

The Basis for Conclusions emphasises that the probability recognition criterion is used in the *Framework* to determine whether it is probable that settlement of an item that has previously been determined to be a liability will require an outflow of economic benefits from the entity. In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. The Basis notes that in many cases, although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require *some* outflow of resources. An example is an entity that has an obligation to decommission plant or to restore previously contaminated land. The Basis also outlines the Board's conclusion that in cases previously described as contingent liabilities in which the entity has an unconditional obligation and a conditional obligation, the probability recognition criterion should be applied to the unconditional obligation (ie the liability) rather than the conditional obligation. So, for example, in the case of a product warranty, the question is not whether it is probable that the entity will be required to repair or replace the product. Rather, the question is whether the entity's *unconditional* obligation to provide warranty coverage for the duration of the warranty (ie to stand ready to honour warranty claims) will probably result in an outflow of economic benefits (see paragraphs BC37-BC41).

The Basis for Conclusions highlights that the *Framework* articulates the probability recognition criterion in terms of an outflow of economic benefits, not just direct cash flows. This includes the provision of services. An entity's unconditional obligation to stand ready to honour a conditional obligation if an uncertain future event occurs (or fails to occur) is a type of service obligation. Therefore, any liability that incorporates an unconditional obligation satisfies the probability recognition criterion. For example, the issuer of a product warranty has a certain (not just probable) outflow of economic benefits because it is providing a service for the duration of the contract, ie it is standing ready to honour warranty claims (see paragraphs BC42-BC47).

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

Question 6 – Measurement

The Exposure Draft proposes that an entity should measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date (see paragraph 29). The Exposure Draft explains that an expected cash flow approach is an appropriate basis for measuring a non-financial liability for both a class of similar obligations and a single obligation. It highlights that measuring a single obligation at the most likely outcome would not necessarily be consistent with the Standard's measurement objective (see paragraph 31).

Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why?

Question 7 – Reimbursements

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).

Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

Question 8 – Onerous contracts

The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be recognised until the entity takes that action. Hence, in the case of a property held under an operating lease that

becomes onerous as a result of the entity's actions (for example, as a result of a restructuring) the liability is recognised when the entity ceases to use the property (see paragraphs 55 and 57). In addition, the Exposure Draft proposes that, if the onerous contract is an operating lease, the unavoidable cost of the contract is the remaining lease commitment reduced by the estimated sublease rentals that the entity could reasonably obtain, regardless of whether the entity intends to enter into a sublease (see paragraph 58).

(a) Do you agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity's own actions should be recognised only when the entity has taken that action? If not, when should it be recognised and why?

(b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability?

(c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?

Question 9 – Restructuring provisions

The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those costs (see paragraphs 61 and 62).

The Exposure Draft proposes guidance (or provides cross-references to other Standards) for applying this principle to two types of costs that are often associated with a restructuring: termination benefits and contract termination costs (see paragraphs 63 and 64).

(a) Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?

(b) Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?

SUMMARY OF MAIN CHANGES (IAS 37)

The following main changes are proposed:

Scope of IAS 37 and terminology

IAS 37 defines a provision as a liability of uncertain timing or amount. The Exposure Draft does not use 'provision' as a defined term and instead proposes to use the term 'non-financial liability', which includes items previously described as provisions as well as other liabilities.

The purpose of this amendment is to clarify that IAS 37, except in specified cases, should be applied to all non-financial liabilities that are not within the scope of other Standards.

Contingent liabilities

IAS 37 defines a contingent liability as a possible obligation or a present obligation that is not recognised. A contingent liability that is a present obligation is not recognised either because it is not probable that an outflow of resources will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability. The Standard does not permit contingent liabilities to be recognised but requires them to be disclosed, unless the possibility of any outflow of economic resources in settlement of the contingent liability is remote. The Exposure Draft:

- proposes eliminating the term 'contingent liability'.
- uses the term 'contingency' to refer to uncertainty about the amount that will be required to settle a liability, rather than uncertainty about whether a liability exists.
- specifies that a liability for which the settlement amount is contingent on one or more uncertain future events is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur).

The purpose of these amendments is:

- to clarify that only present obligations (rather than possible obligations) of an entity give rise to liabilities and that liabilities arise from unconditional obligations.
- to require uncertainty about future events that affect the amount that will be required to settle a liability to be reflected in the measurement of the liability.

Contingent assets

- IAS 37 defines a contingent asset as a possible asset. It does not permit contingent assets to be recognised, but requires them to be disclosed if an inflow of economic benefits is probable. The Exposure Draft:
  - proposes eliminating the term 'contingent asset'.
  - uses the term 'contingency' to refer to uncertainty about the amount of the future economic benefits embodied in an asset, rather than uncertainty about whether an asset exists.
  - specifies that items previously described as contingent assets, but satisfying the definition of an asset in the *Framework*, are within the scope of IAS 38 rather than IAS 37 (except for rights to reimbursements, which remain within the scope of IAS 37).
- The purpose of the amendment is to clarify that only resources currently controlled by the entity as a result of a past transaction or event (rather than possible assets) give rise to assets and that assets arise from unconditional rights.

Constructive obligations

IAS 37 defines a constructive obligation as an obligation that derives from an entity's actions when the entity has (a) indicated to other parties that it will accept particular responsibilities and (b) as a result has created a valid expectation on the part of those other parties that it will discharge those responsibilities. The Exposure Draft proposes:

- to amend the definition of a constructive obligation to clarify that the actions of an entity must result in other parties having a valid expectation that they can reasonably rely on the entity to discharge its responsibilities.

- to provide additional guidance on determining whether an entity has incurred a constructive obligation.

Probability recognition criterion

- IAS 37 states that provisions should be recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the provision. In some cases, the examples accompanying the Standard apply this probability recognition criterion to what the Exposure Draft now analyses as conditional obligations. For example, in the case of a product warranty, the Standard explains that the entity considers the likelihood of claims arising under the warranty. In effect, this means that the entity considers whether it is probable that the *conditional* obligation will result in an outflow of resources embodying economic benefits. Consistently with the revised analysis of contingent liabilities, the Basis for Conclusions explains that the probable outflow criterion should always be applied to the liability (ie unconditional obligation). Therefore, if an entity has a non-financial liability arising from an unconditional obligation that is accompanied by a conditional obligation, the probability recognition criterion is applied to the unconditional obligation rather than the conditional obligation. For example, in the case of a product warranty, the criterion should be applied to the unconditional obligation to stand ready to honour warranty claims (ie to provide warranty coverage). As a result, the Basis for Conclusions highlights that the probability recognition criterion is always satisfied. The Exposure Draft therefore proposes omitting the criterion from the Standard.

Measurement

- IAS 37 states that provisions should be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The best estimate is described as the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time. Although expected value is described as the basis for measuring a provision involving a large population of items, the Standard states that the best estimate of single obligations may be the individual most likely outcome. The Exposure Draft:
  - proposes that a non-financial liability should be measured at the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date.

  - emphasises that an expected cash flow approach can be used as the basis for measuring a non-financial liability for both a class of similar obligations and a single obligation.
  - explains that measuring a non-financial liability for a single obligation at its most likely outcome would not necessarily be consistent with the Standard's measurement objective.

Reimbursement

- IAS 37 states that when expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when it is virtually certain that the reimbursement will be received. Consistently with the revised analysis of a contingent asset, the Exposure Draft proposes that if an entity has an unconditional right to receive reimbursement, that right should be recognised as an asset if it can be measured reliably.

Onerous contracts

- IAS 37 defines an onerous contract as one in which the unavoidable costs of meeting its obligations exceed the economic benefits expected. The entity recognises as a provision the present obligation under the contract. The Standard provides no further guidance about when the provision should be recognised. The Exposure Draft proposes:
  - additional recognition guidance to specify that if a contract will become onerous as a result of an entity's own action, the liability should not be recognised until the entity has taken that action.
  - specifying that in the case of an onerous operating lease, the unavoidable costs of meeting the obligation should be based on the unavoidable lease commitment less any sublease rentals that the entity could reasonably obtain for the property, regardless of whether the entity intends to sublease the property.

Restructuring provisions

- IAS 37 states that an entity that (a) has a detailed formal plan for restructuring and (b) has raised a valid expectation in those affected that it will carry out the restructuring has a constructive obligation. Therefore, it recognises a provision for the direct expenditures arising from the restructuring. The Exposure Draft proposes:
  - revising the application guidance for restructuring provisions to specify that a non-financial liability for a cost associated with a restructuring is recognised only when the definition of a liability has been satisfied for that cost. Accordingly, a cost associated with a restructuring is recognised as a liability on the same basis as if that cost arose independently of a restructuring.
  - specific guidance for accounting for costs that are often associated with a restructuring as follows:
    - the cost of employee termination benefits is recognised in accordance with IAS 19 *Employee Benefits*.
    - a liability for costs that will continue to be incurred under a contract for its remaining term without equivalent economic benefit to the entity is recognised when the entity ceases using the right conveyed by the contract (in addition to any liability recognised if the contract was previously determined to be onerous).
    - the cost of terminating a contract before the end of its term is recognised when the entity terminates the contract in accordance with the contract terms.

IASB Exposure Draft June 2005

Contents

[Draft] International Accounting Standard 37 *Non-financial Liabilities* ([draft] IAS 37) is set out in paragraphs 1-73 and the Appendix. All the paragraphs have equal authority but retain the IASC format of the Standard when it was adopted by the IASB. [Draft] IAS 37 should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

IASB Exposure Draft June 2005

[DRAFT] INTERNATIONAL ACCOUNTING STANDARD 37

NON-FINANCIAL LIABILITIES

Objective

1 The objective of this [draft] Standard is to establish principles for recognising, measuring and disclosing non-financial liabilities. Those principles require an entity to recognise a non-financial liability unless it cannot be measured reliably. Uncertainty about the amount or timing of the economic benefits that will be required to settle a non-financial liability is reflected in the measurement of that liability. The principles also require an entity to disclose sufficient information to enable users of the financial statements to understand the amount and nature of an entity's non-financial liabilities and the uncertainty relating to the future outflows of economic benefits that will be required to settle them.

Scope

2 An entity shall apply this [draft] Standard in accounting for all non-financial liabilities, except:

(a) those resulting from executory contracts, unless the contract is onerous; and

(b) those within the scope of another Standard.

3 Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

4 When a specific type of non-financial liability is within the scope of another Standard, an entity applies that Standard instead of this [draft] Standard. For example, some types of non-financial liabilities are within the scope of Standards on:

(a) construction contracts (see IAS 11 *Construction Contracts*).

(b) income taxes (see IAS 12 *Income Taxes*).

(c) employee benefits (see IAS 19 *Employee Benefits*).

(d) insurance contracts (see IFRS 4 *Insurance Contracts*). However, this [draft] Standard applies to non-financial liabilities of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of IFRS 4.

5 An entity shall apply this [draft] Standard to the following contractual obligations only if they are onerous:

(a) obligations under operating leases to which IAS 17 *Leases* applies; and

(b) loan commitments excluded from the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

6 Because IAS 17 contains no specific requirements for operating leases that are onerous, this [draft] Standard applies to such leases. Similarly, because IAS 39 excludes some loan commitments from its scope, this [draft] Standard applies to such loan commitments if they are onerous.

7 Some amounts treated as non-financial liabilities may relate to the recognition of revenue, for example when an entity issues a product warranty in exchange for a fee. This [draft] Standard does not address the recognition of revenue. IAS 18 *Revenue* identifies the circumstances in which revenue is recognised and provides guidance on the application of the recognition criteria. This [draft] Standard does not change the requirements of IAS 18.

8 Other Standards specify whether the corresponding amount recognised for a non-financial liability is included as part of the cost of an asset or recognised as an expense. This issue is not addressed in this [draft] Standard.

9 In some jurisdictions, some classes of liabilities are described as provisions, for example those liabilities that can be measured only by using a substantial degree of estimation. Although this [draft] Standard does not use the term 'provision', it does not prescribe how entities should describe

their non-financial liabilities. Therefore, entities may describe some classes of non-financial liabilities as provisions in their financial statements.

Definitions

10 The following terms are used in this [draft] Standard with the meanings specified:

A *constructive obligation* is a present obligation that arises from an entity's past actions when:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities; and

(b) as a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.

A *legal obligation* is a present obligation that arises from the following:

(a) a contract (through its explicit or implicit terms);

(b) legislation; or

(c) other operation of law.

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.

A *non-financial liability* is a liability other than a financial liability as defined in IAS 32 *Financial Instruments: Disclosure and Presentation*.

A contract is *onerous* when the unavoidable costs of meeting its obligations exceed its expected economic benefits.

Recognition

11 An entity shall recognise a non-financial liability when:

(a) the definition of a liability has been satisfied, and

(b) the non-financial liability can be measured reliably.

Satisfying the definition of a liability

12 Items are recognised as non-financial liabilities in accordance with this [draft] Standard only if they satisfy the definition of a liability in the *Framework*.

13 An essential characteristic of a liability is that the entity has a present obligation arising from a past event. For a past event to give rise to a present obligation, the entity must have little, if any, discretion to avoid settling it. A past event that creates a present obligation is sometimes referred to as an obligating event.

14 Because most liabilities arise from legal obligations, settlement can be enforced by a court. Some liabilities arise from constructive obligations, in which the obligation is created by, or inferred from, an entity's past actions rather than arising from an explicit agreement with another party or from legislation. In some jurisdictions, constructive obligations may also be enforced by a court, for example in accordance with the legal principle known in the United States as promissory estoppel[1] or principles having the same effects under other legal systems.

15 In the absence of legal enforceability, particular care is required in determining whether an entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this will be the case only if:

[1] Defined in *Black's Law Dictionary* as 'the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment.'

(a) the entity has indicated to other parties that it will accept particular responsibilities;

(b) the other parties can reasonably expect the entity to perform those responsibilities; and

(c) the other parties will either benefit from the entity's performance or suffer harm from its non-performance.

16 In determining whether a liability exists at the balance sheet date, an entity takes into account all available evidence, for example the opinion of experts. The evidence considered includes any additional information provided by events after the balance sheet date, but only to the extent that the information provides evidence of circumstances that existed at the balance sheet date.

17 Only present obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) result in liabilities. For example, an entity has a liability for its obligation to decommission an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. Regardless of its future actions, the entity has little, if any, discretion to avoid settling that obligation.

18 An intention to incur an outflow of economic resources embodying economic benefits in the future is not sufficient to give rise to a liability, even if the outflow is necessary for the continuation of the entity's future operations. For example, because of commercial pressures or legal requirements, an entity may intend or need to incur expenditure to operate in a particular way in the future (for example, by installing smoke filters in a particular type of factory). Because the entity has the discretion to avoid the future expenditure by its future actions, for example by changing its operations, it has no present obligation for that future expenditure and a liability does not exist.

19 A present obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the specific party to whom the obligation is owed—indeed, the obligation may be to the public at large. Because a liability always involves an obligation to another party, it follows that a decision by the management of an entity does not

normally give rise to a present obligation at the balance sheet date. A present obligation arises only if the decision has been communicated before the balance sheet date to those it affects in a sufficiently specific manner to raise a valid expectation in them that they can reasonably rely on the entity to perform.

20 An event that does not give rise to a present 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 present obligation to remedy the consequences. However, a present obligation arises if a new law requires the existing damage to be rectified or if the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

21 When a new law is proposed, a present obligation under the operation of that law arises only when the law is substantively enacted, which is when the remaining steps in the enactment process will not change the outcome. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make legislation substantively enacted in all jurisdictions. In some cases, substantive enactment does not occur until the legislation is actually enacted.

Contingencies

22 In some cases, an entity has a liability even though the amount that will be required to settle that liability is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In such cases, an entity has incurred two obligations as a result of a past event—an unconditional obligation and a conditional obligation.

23 When the amount that will be required to settle a liability is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability arising from the unconditional obligation is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur). Uncertainty about the future event(s) is reflected in the measurement of the liability recognised.

24 Liabilities for which the amount that will be required in settlement is contingent on the occurrence or non-occurrence of a future event are

sometimes referred to as 'stand ready' obligations. This is because the entity has an unconditional obligation to stand ready to fulfil the conditional obligation *if* the uncertain future event occurs (or fails to occur). The liability is the unconditional obligation to provide a service, which results in an outflow of economic benefits.

25 An example of a stand ready obligation is a product warranty. The issuer of a product warranty has an unconditional obligation to stand ready to repair or replace the product (or, expressed another way, to provide warranty coverage over the term of the warranty) and a conditional obligation to repair or replace the product if it develops a fault. The issuer recognises its liability arising from its unconditional obligation to provide warranty coverage. Uncertainty about whether the product will require repair or replacement (ie the conditional obligation) is reflected in the measurement of the liability.

26 Similarly, an entity that is involved in defending a lawsuit recognises the liability arising from its unconditional obligation to stand ready to perform as the court directs. Uncertainty about the possible penalties the court may impose (ie the conditional obligation) is reflected in the measurement of the liability.

Reliable measurement

27 In many cases, the amount of a non-financial liability must be estimated. The use of estimates is an essential part of the preparation of financial statements and does not of itself undermine the reliability of the statements. Except in extremely rare cases, an entity will be able to determine a reliable measure of a liability.

28 In the extremely rare case in which an entity cannot measure reliably a non-financial liability, the liability does not qualify for recognition in accordance with this [draft] Standard. In such cases, the entity discloses information about the non-financial liability in accordance with paragraph 69. The non-financial liability is recognised initially in the period in which it can be measured reliably.

Measurement

Amount that an entity would rationally pay to settle or transfer the obligation

29 An entity shall measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date.

30 In some cases, contractual or other market evidence can be used to determine the amount that would be required to settle or transfer the obligation on the balance sheet date. However, in many cases, observable market evidence of the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party will not exist and the amount must be estimated.

31 The basis of estimating many non-financial liabilities will be an expected cash flow approach, in which multiple cash flow scenarios that reflect the range of possible outcomes are weighted by their associated probabilities. An expected cash flow approach is an appropriate basis for measuring both liabilities for a class of similar obligations and liabilities for single obligations. This is because it is likely to be the basis of the amount that an entity would rationally pay to settle the obligation(s) or to transfer the obligation(s) to a third party on the balance sheet date. In contrast, a liability for a single obligation measured at its most likely outcome would not necessarily represent the amount that the entity would rationally pay to settle or to transfer the obligation on the balance sheet date.

32 The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience with similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional information provided by events after the balance sheet date, but only to the extent that the information relates to the obligation existing at the balance sheet date.

33 When an entity is estimating the amount of a non-financial liability that is contingent on the occurrence (or non-occurrence) of one or more uncertain future events, the measurement of the liability reflects the uncertainty about the future event(s). For example, in estimating a liability for a

product warranty obligation, an entity considers the likelihood of claims under the warranty occurring and the amount and timing of the cash flows that would be required to meet those claims.

34 The non-financial liability is measured before tax, because the tax consequences of the liability, and changes in it, are accounted for in accordance with IAS 12.

Risks and uncertainties

35 In measuring a non-financial liability in accordance with paragraph 29, an entity shall include the effects of risks and uncertainties.

36 Risk describes variability of outcome. A risk adjustment typically increases the amount at which a liability is measured relative to a measurement that does not include a risk adjustment, all other things being equal. This is because it reflects the price that entities demand for the uncertainties and unforeseeable circumstances inherent in the liability. Caution is needed in making judgements under conditions of uncertainty, so that liabilities are not understated. However, uncertainty does not justify deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated at the high end of the range of those reasonably expected, 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 non-financial liability.

37 The uncertainties about the amount or timing of the outflow of economic benefits are disclosed in accordance with paragraph 68(c).

Present value

38 When an entity measures a non-financial liability using an estimation method that involves projections of future cash flows, it shall discount the cash flows using 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.[2]

39 Because of the time value of money, estimated cash outflows that arise soon after the balance sheet date are more onerous than those of the same amount that arise later. Therefore, cash flows are discounted.

40 When an entity reflects the effects of risks and uncertainties by adjusting the discount rate rather than by adjusting the estimated cash flows, the resulting discount rate is typically lower than a risk-free rate.

Future events

41 When measuring a non-financial liability, an entity shall reflect the effects of future events that may affect the amount that will be required to settle the obligation.

42 Only the effects of future events that may affect the amount that will be required to settle an obligation without changing the nature of the obligation are reflected in the measurement of a non-financial liability. For example, an entity's past experience may indicate that the cost of cleaning up a site at the end of its life may be reduced by future changes in technology. Accordingly, when measuring the liability, the entity reflects an assessment of both the assumed effects of the future technology on the cost of cleaning up the site and the likelihood that such technology will be available. In contrast, the effects of future events that create new obligations (or change or discharge existing obligations) are not reflected in the measurement of a liability. For example, the effects of possible new legislation are not reflected in the measurement of a liability because they create or change the obligation itself.

Subsequent measurement

43 An entity shall review the carrying amount of a non-financial liability at each balance sheet date and adjust it to reflect the current amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party on that date.

[2] Further guidance on using cash flow information and present value in accounting measurements is contained in Appendix A of IAS 36 *Impairment of Assets.*

44 An entity subsequently remeasures a non-financial liability in accordance with paragraphs 30-42. Therefore, remeasurement reflects any changes in:

(a) the expected amount and timing of the economic benefits that will be required to settle the obligation;

(b) the risks and uncertainties surrounding the obligation; and

(c) the discount rate used to measure the liability.

45 Changes in the carrying amount of a non-financial liability resulting from the passage of time are recognised as a borrowing cost.

Reimbursements

46 When an entity has a right to be reimbursed by a third party for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably. The amount recognised for the reimbursement right shall not exceed the amount of the non-financial liability.

47 Sometimes, an entity has a right to look to another party to provide part or all of the economic benefits that will be required to settle a non-financial liability (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or settle the amounts directly. Although the reimbursement itself is a conditional right, the unconditional right to receive reimbursement satisfies the definition of an asset and is recognised if it can be measured reliably.

48 An entity shall not offset against the non-financial liability the amount recognised for the reimbursement right.

49 Because the reimbursement is receivable from a third party, there would not be a legally enforceable right of set-off and, therefore, the non-financial liability and the reimbursement right are recognised separately. However, if the entity will not be liable for the amounts required to settle the

obligation if the third party fails to pay, the entity has no liability for these amounts and they are not reflected in the measurement of the liability.

50 In the income statement, the expense relating to a non-financial liability may be presented net of the income resulting from the reimbursement right.

Derecognition

51 An entity shall derecognise a non-financial liability when the obligation is settled, is cancelled or expires.

Application of the recognition and measurement requirements

Future operating losses

52 An entity shall not recognise a liability for future operating losses.

53 Future operating losses do not satisfy the definition of a liability because there is no present obligation arising from a past event.

54 An expectation by the entity of future operating losses is an indication that some assets of the entity may be impaired or that some of its contracts may be onerous. An entity tests these assets for impairment in accordance with IAS 36 *Impairment of Assets* and accounts for its onerous contracts in accordance with paragraphs 55-59.

Onerous contracts

55 If an entity has a contract that is onerous, it shall recognise as a liability the present obligation under the contract. If the contract will become onerous as a result of the entity's own actions, the entity shall not recognise the liability until it has taken the action.

56 Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party and, therefore, there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. If events or circumstances make such a contract onerous, the contract is within the scope of this [draft] Standard and a liability exists that is recognised. Executory contracts that are not onerous are outside the scope of this [draft] Standard.

57 In some cases, contracts become onerous as a result of events outside the entity's control. For example, a contract that requires an entity to make specified payments regardless of whether it takes delivery of contracted products or services may become onerous if the market price of the products or services declines below the contracted price. In other cases, the event that makes the contract onerous is an action of the entity. In such cases, the liability for the onerous contract is not recognised until the entity has taken the action. For example, a contract may become onerous because the entity ceases to use the right conveyed by that contract, but continues to incur costs for its obligations under the contract. Therefore, in this example the entity does not recognise a liability until it ceases using the right conveyed by the contract.

58 A contract is onerous when the unavoidable costs of meeting its obligations exceed its expected economic benefits. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. If the contract is an operating lease, the entity determines the unavoidable cost by reference to the remaining lease rentals payable, reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease.

59 Before an entity recognises a liability for an onerous contract, it recognises any impairment loss that has occurred on assets related to that contract (see IAS 36).

Restructurings

60 The following are examples of events that are typically described as a restructuring:

(a) sale or termination of a line of business;

(b) closure of business locations in a country or region or relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) reorganisations that affect the nature and focus of the entity's operations.

61 An entity shall recognise a non-financial liability for a cost associated with a restructuring only when the definition of a liability has been satisfied.

62 A liability involves a present obligation to others that leaves the entity with little, if any, discretion to avoid settling the obligation. A decision by the management of an entity to undertake a restructuring does not create a present obligation to others for costs expected to be incurred during the restructuring. Accordingly, a decision by the management of an entity to undertake a restructuring is not the requisite past event for the recognition of a liability. A cost associated with a restructuring is recognised as a liability on the same basis as if that cost arose independently of the restructuring. Paragraphs 63-65 provide additional guidance for applying the definition of a liability to specified costs that are often associated with a restructuring.

Termination benefits

63 An entity shall apply the requirements in paragraphs 132-147 of [draft] IAS 19 to benefits that are provided in connection with the termination of an employee's employment.

Contract termination costs

64 An entity shall apply the requirements in paragraphs 55-59 to costs to terminate a contract before the end of its term and to costs that will continue to be incurred under a contract for its remaining term without

equivalent economic benefit to the entity. Accordingly, a liability for costs to terminate a contract that was not previously determined to be an onerous contract before the end of its term shall be recognised when the entity terminates the contract in accordance with the contract terms. For example, termination would occur when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty. Similarly, a liability for costs that will continue to be incurred under a contract that was not previously determined to be onerous for its remaining term without economic benefit to the entity shall be recognised when the entity ceases using the right conveyed by the contract. For example, any additional liability for payments to be made under an operating lease for a factory that will no longer be used is recognised when the entity ceases to use the leased factory.

Other associated costs

65 Other costs associated with a restructuring include, but are not limited to, such costs as:

(a) retraining or relocating continuing staff;

(b) consolidating or closing facilities; or

(c) investing in new systems and distribution networks.

An entity shall recognise liabilities for such costs when the liability is incurred (generally, when goods or services associated with the activity are received).

66 If an entity starts to implement a restructuring plan or announces its main features after the balance sheet date, disclosure is required in accordance with IAS 10 *Events after the Balance Sheet Date*.

Disclosure

67 For each class of recognised non-financial liability, an entity shall disclose the carrying amount of the liability at the period-end together with a description of the nature of the obligation.

68 For any class of recognised non-financial liability with estimation uncertainty, an entity shall also disclose:

(a) a reconciliation of the carrying amounts at the beginning and end of the period showing:

(i) liabilities incurred;

(ii) liabilities derecognised;

(iii) changes in the discounted amount resulting from the passage of time and the effect of any change in the discount rate; and

(iv) other adjustments to the amount of the liability (eg revisions in estimated cash flows that will be required to settle it).

(b) the expected timing of any resulting outflows of economic benefits.

(c) an indication of the uncertainties about the amount or timing of those outflows. If necessary to provide adequate information, an entity shall disclose the major assumptions made about future events, as described in paragraph 41.

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

69 If a non-financial liability is not recognised because it cannot be measured reliably, an entity shall disclose that fact together with:

(a) a description of the nature of the obligation;

(b) an explanation of why it cannot be measured reliably;

(c) an indication of the uncertainties relating to the amount or timing of any outflow of economic benefits; and

(d) the existence of any right to reimbursement.

70 In determining which non-financial liabilities may be aggregated to form a class, an entity considers whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs 67-69. Thus, it may be appropriate to treat as a single class of non-financial liabilities amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts subject to legal proceedings.

71 In extremely rare cases, disclosure of some or all of the information required by paragraphs 68 and 69 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the non-financial liability. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Transition and effective date

72 An entity shall apply this [draft] Standard from the beginning of its first annual period commencing on or after [1 January 2007]. Comparative information shall not be restated. Earlier application is encouraged. However, an entity shall apply this [draft] Standard only from the beginning of an annual period commencing on or after [date the [draft] Standard is issued]. If an entity applies this [draft] Standard before the effective date, it shall disclose that fact.

Withdrawal of IAS 37 (issued 1998)

73 This [draft] Standard supersedes IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (issued in 1998).

Appendix

Amendments to other pronouncements

The amendments in this [draft] Appendix shall be applied from the beginning of annual periods commencing on or after [1 January 2007]. If an entity applies this [draft] Standard from the beginning of an earlier annual period, these amendments shall be applied for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

A1 In International Financial Reporting Standards (including International Accounting Standards and Interpretations) applicable at [1 January 2007] references to the current version of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are amended to IAS 37 *Non-financial Liabilities*.

A2 IFRS 1 *First-time Adoption of International Financial Reporting Standards* is amended as described below.

Paragraphs 9, 10, 12 and 26 are amended as follows.

9 The transitional provisions in other IFRSs apply to changes in accounting policies made by an entity that already uses IFRSs; they do not apply to a *first-time adopter's* transition to IFRSs, except as specified in paragraphs 25D~~,~~ and 34A ~~and 34B~~ -34C.

10 Except as described in paragraphs 13-34C, an entity shall, in its opening IFRS balance sheet:

…

12 This IFRS establishes two categories of exceptions to the principle that an entity's opening IFRS balance sheet shall comply with each IFRS:

…

(b) paragraphs 26-34~~B~~C prohibit retrospective application of some aspects of other IFRSs.

26 This IFRS prohibits retrospective application of some aspects of other IFRSs relating to:

…

(c) estimates (paragraphs 31-34); ~~and~~

(d) assets classified as held for sale and discontinued operations (paragraphs 34A and 34B)~~.~~; and

(e) non-financial liabilities (paragraph 34C).

After paragraph 34B a new heading and paragraph 34C are added as follows.

Non-financial liabilities

34C A first-time adopter shall apply IAS 37 (as revised in [2006]) for annual periods and comparative periods beginning on or after [1 January 2007]. A first-time adopter is encouraged, but not required, to apply IAS 37 (as revised in [2006]) for annual periods and comparative periods beginning on or after [date revised IAS 37 is issued]. Otherwise, it shall apply the version of IAS 37 in effect before the revisions made in [2006].

In the Implementation Guidance, Example 1 is amended as follows.

Background

Entity A's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for one year. In its previous GAAP financial statements for 31 December 2003 and 2004, entity A:

(a) made estimates of accrued expenses and ~~provisions~~ other liabilities at those dates; and
(b) accounted on a cash basis for a defined benefit pension plan~~.~~; ~~and~~
~~(c) did not recognise a provision for a court case arising from events that occurred in September 2004. When the court case was concluded on 30 June 2005, entity A was required to pay 1,000 and paid this on 10 July 2005.~~

In preparing its first IFRS financial statements, entity A concludes that its estimates under previous GAAP of accrued expenses and ~~provisions~~ other liabilities at 31 December 2003 and 2004 were made on a basis consistent with its accounting policies under IFRSs. Although some of the accruals and ~~provisions~~ liabilities turned out to be overestimates and others to be underestimates, entity A concludes that its estimates were reasonable and that, therefore, no error had occurred. As a result, accounting for those over- and underestimates involves the routine adjustment of estimates under IAS 8.

Application of requirements

In preparing its opening IFRS balance sheet at 1 January 2004 and in its comparative balance sheet at 31 December 2004, entity A:

(a) does not adjust the previous estimates for accrued expenses and ~~provisions~~ other liabilities; and

(b) makes estimates (in the form of actuarial assumptions) necessary to account for the pension plan under IAS 19 *Employee Benefits*. Entity A's actuarial assumptions at 1 January 2004 and 31 December 2004 do not reflect conditions that arose after those dates. For example, entity A's:
   (i) discount rates at 1 January 2004 and 31 December 2004 for the pension plan and for ~~provisions~~ other liabilities reflect market conditions at those dates; and
   (ii) actuarial assumptions at 1 January 2004 and 31 December 2004 about future employee turnover rates do not reflect conditions that arose after those dates—such as a significant increase in estimated employee turnover rates as a result of a curtailment of the pension plan in 2005.

~~The treatment of the court case at 31 December 2004 depends on the reason why entity A did not recognise a provision under previous GAAP at that date.~~

~~**Assumption 1** — Previous GAAP was consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Entity A concluded that the recognition criteria were not met. In this case, entity A's assumptions under IFRSs are consistent with its assumptions under previous GAAP. Therefore, entity A does not recognise a provision at 31 December 2004.~~

~~**Assumption 2** — Previous GAAP was not consistent with IAS 37. Therefore, entity A develops estimates under IAS 37. Under IAS 37, an entity determines whether an obligation exists at the balance sheet date by taking account of all available evidence, including any additional evidence provided by events after the balance sheet date. Similarly, under IAS 10 *Events after the Balance Sheet Date*, the resolution of a court case after the balance sheet date is an adjusting event after the balance sheet date if it confirms that the entity had a present obligation at that date. In this instance, the resolution of the court case confirms that entity A had a liability in September 2004 (when the events occurred that gave rise to the court case). Therefore, entity A recognises a provision at 31 December 2004. Entity A measures that provision by discounting the 1,000 paid on 10 July 2005 to its present value, using a discount rate that complies with IAS 37 and reflects market conditions at 31 December 2004.~~

In paragraph IG13 of the Implementation Guidance, 'provision' is amended to 'non-financial liability'.

In the Implementation Guidance, Example 3 is amended as follows.

IG Example 3 Business combination—liability for costs associated with a restructuring ~~provision~~

Background

Entity D's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for 2004 only. On 1 July 2003, entity D acquired 100 per cent of subsidiary E. Amounts reported as liabilities by entity D in accordance with ~~Under~~ its previous GAAP~~, entity D recognised an (undiscounted)~~ included expected restructuring ~~provision~~ costs of 100 that would not have qualified as an identifiable liability under IFRS 3. The recognition of ~~this restructuring provision~~ these costs as a liability increased goodwill by 100. At 31 December 2003 (date of transition to IFRSs), entity D:

(a) had paid restructuring costs of 60; and
(b) estimated that it would pay further costs of 40 in 2004, and that the effects of discounting were immaterial. At 31 December 2003, those further costs did not qualify for recognition as a ~~provision under~~ non-financial liability in accordance with IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities*.

Application of requirements

In its opening IFRS balance sheet, entity D:

(a) does not recognise a liability for restructuring ~~provision~~ costs (paragraph B2(c) of the IFRS).

(b) does not adjust the amount assigned to goodwill. However, entity D tests the goodwill for impairment ~~under~~ in accordance with IAS 36 *Impairment of Assets*, and recognises any resulting impairment loss (paragraph B2(g)).

(c) as a result of (a) and (b), reports retained earnings in its opening IFRS balance sheet that are higher by 40 (before income taxes, and before recognising any impairment loss) than in the balance sheet at the same date under previous GAAP.

In paragraphs IG40 and IG41 of the Implementation Guidance, 'provision' is amended to 'non-financial liability'.

After paragraph IG41 of the Implementation Guidance, example 10A is added as follows.

IG Example 10A IAS 37—recognition of a non-financial liability not recognised in accordance with previous GAAP

Background

Entity A's first IFRS financial statements have a reporting date of 31 December 2008 and include comparative information for one year. In its previous GAAP financial statements for 31 December 2007, entity A did not recognise a liability for a lawsuit filed in December 2007 relating to events that were alleged to have occurred in September 2007. When the ensuing court case was concluded on 30 June 2008, entity A was required to pay 1,000.

Application of requirements

In preparing its opening IFRS balance sheet at 1 January 2007 and in its comparative balance sheet at 31 December 2007, entity A develops estimates necessary to account for the lawsuit in accordance with IAS 37. IAS 37 requires an entity to determine whether an obligation exists at the balance sheet date by taking account of all available evidence, including any additional evidence provided by events after the balance sheet date, but only to the extent that the information provides evidence of circumstances that existed at the balance sheet date. Similarly, in accordance with IAS 10 *Events after the Balance Sheet Date*, the receipt of information after the balance sheet date is an adjusting event after the balance sheet date if it indicates that the entity had a present obligation at that date. In this example, the start of legal proceedings indicates that the entity had a liability at 31 December 2007. Therefore, entity A recognises a non-financial liability at 31 December 2007. Entity A measures that liability by estimating the amount that it would have rationally paid to settle or transfer the obligation on 31 December 2007. Accordingly, measurement reflects the circumstances existing on 31 December 2007.

In the Implementation Guidance, paragraph IG42 is amended as follows.

IG42 The transitional provisions in IAS 36 ~~and IAS 37~~ do not apply to an entity's opening IFRS balance sheet (paragraph 9 of the IFRS). Paragraph 34C of the IFRS specifies when a first-time adopter applies [draft] IAS 37 (as revised in [2006]). For example, a first-time adopter that has a reporting date for its first IFRS financial statements of 31 December 2007 and presents comparative information in those financial statements for one year, is required to apply IAS 37 (as revised in [2006]) from [1 January 2007]. The first-time adopter applies in its comparative information the version of IAS 37 in effect before the revisions made in [2006].

In Example 11 of the Implementation Guidance, in the reconciliation of equity at 1 January 2004, notes 7 and 9 to the reconciliation of equity at 1 January 2004, and note 4 to the reconciliation of profit or loss for 2004, 'restructuring provision' is amended to 'liability for costs associated with restructuring'.

In the Implementation Guidance, paragraph IG201 is amended as follows.

IG201 IAS 16 requires the cost of an item of property, plant and equipment to include the initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located. IAS 37 requires the liability, both initially and subsequently, to be measured at the amount ~~required~~ that an entity would rationally pay to settle the present obligation or to transfer it to a third party ~~at~~ on the balance sheet date~~, reflecting a current market-based discount rate~~.

A3 IFRS 4 *Insurance Contracts* is amended as described below.

Paragraph 14(a) is amended as follows.

(a) shall not recognise as a liability any ~~provisions~~ amounts for possible future claims, if those claims arise under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions).

In the Implementation Guidance, 'provisions' in paragraphs IG22 and IG45 is amended to 'liabilities'.

In the Implementation Guidance, paragraph IG50 is amended as follows.

IG50 An insurer might also disclose the following information, which need not be disaggregated by broad classes:

…

(e) the terms of any obligation ~~or contingent~~ (including a stand ready obligation) for the insurer to contribute to government or other guarantee funds (see also IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities*).

…

A4 IAS 1 *Presentation of Financial Statements* is amended as described below.

Paragraphs 34(b), 56, 68, 75, 87, 105, 117 and 124 are amended as follows.

34(b) ~~expenditure~~ the expense related to a ~~provision~~ non-financial liability that is recognised in accordance with IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities* and ~~reimbursed under a contractual arrangement with~~ for which the entity has a right to reimbursement from a third party (for example, a supplier's warranty agreement) may be netted against the income resulting from the related reimbursement right.

56 Information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity. IAS 32 requires disclosure of the maturity dates of financial assets and financial liabilities. Financial assets include trade and other receivables, and financial liabilities include trade and other payables. Information on the expected date of recovery and settlement of non-monetary assets and liabilities such as inventories and ~~provisions~~ non-financial liabilities is also useful, whether or not assets and liabilities are classified as current or non-current. For example, an entity discloses the amount of inventories that are expected to be recovered more than twelve months after the balance sheet date.

68 As a minimum, the face of the balance sheet shall include line items that present the following amounts to the extent that they are not presented in accordance with paragraph 68A:

…

(d) financial assets (excluding amounts shown under (e), (h) ~~and~~ or (i));

…

(j) trade and other payables;

~~(k) provisions;~~

(~~l~~k) financial liabilities (excluding amounts shown under (j) ~~and (k)~~);

(l) non-financial liabilities (excluding amounts shown under (m) or (n));

...

75 The detail provided in subclassifications depends on the requirements of IFRSs and on the size, nature and function of the amounts involved. The factors set out in paragraph 72 also are used to decide the basis of subclassification. The disclosures vary for each item, for example:

…

(d) ~~provisions are disaggregated into provisions for employee benefits and other items~~ non-financial liabilities are disaggregated into classes in accordance with IAS 37; and

…

87 Circumstances that would give rise to the separate disclosure of items of income and expense include:

…

(b) costs associated with restructuring~~s of~~ the activities of an entity ~~and reversals of any provisions for the costs of restructuring~~;

…

(g) ~~other~~ reversals of ~~provisions~~ non-financial liabilities.

105 Notes are normally presented in the following order, which assists users in understanding the financial statements and comparing them with financial statements of other entities:

…

(d) other disclosures, including:

(i) ~~contingent liabilities~~ non-financial liabilities that have not been recognised ~~(see~~ in accordance with IAS 37~~)~~ and unrecognised contractual commitments; and

…

117 Determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the balance sheet date. For example, in the absence of recently observed market prices used to measure the following assets and liabilities, future-oriented estimates are necessary to measure:

(a) the recoverable amount of classes of property, plant and equipment,

(b) the effect of technological obsolescence on inventories,

(c) ~~provisions~~ non-financial liabilities subject to the future outcome of litigation in progress, and

(d) long-term employee benefit liabilities such as pension obligations.

These estimates involve assumptions about such items as the risk adjustment to cash flows or discount rates used, future changes in salaries and future changes in prices affecting other costs.

124 The disclosure of some of the key assumptions that would otherwise be required in accordance with paragraph 116 is required by other Standards. For example, IAS 37 requires disclosure, in specified circumstances, of major assumptions concerning future events affecting classes of ~~provisions~~ non-financial liabilities. IAS 32 requires disclosure of significant assumptions ~~applied~~ made in estimating fair values of financial assets and financial liabilities that are carried at fair value. IAS 16 requires disclosure of significant assumptions ~~applied~~ made in estimating fair values of revalued items of property, plant and equipment.

In the Implementation Guidance, in the illustrative balance sheet after paragraph IG4, ‘provisions’ is amended to ‘non-financial liabilities’.

A5 In IAS 2 *Inventories*, 'provisions' in paragraph 31 is amended to 'liabilities'.

A6 In IAS 7 *Cash Flow Statements*, 'provisions' in paragraph 20(b) is amended to 'non-financial liabilities'.

A7 In IAS 10 *Events after the Balance Sheet Date*, paragraphs 9, 20 and 22 are amended as follows.

9 The following are examples of adjusting events after the balance sheet date that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

(a) the ~~settlement~~ receipt of information after the balance sheet date ~~of a court case~~ that ~~confirms~~ indicates that the entity had a present obligation at the balance sheet date. The entity ~~adjusts any previously recognised provision related to this court case~~ recognises a non-financial liability in accordance with IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities* ~~or recognises a new provision. The entity does not merely disclose a contingent liability~~ because the ~~settlement~~ information provides additional evidence that would be considered in accordance with paragraph 16 of IAS 37. For example, the start of legal proceedings against an entity after the balance sheet date may indicate that the entity had a present obligation at the balance sheet date.

…

20 In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the balance sheet date, even when the information does not affect the amounts that it recognises in its financial statements. One example of the need to update disclosures is when evidence becomes available after the balance sheet date about a ~~contingent~~ non-financial liability that existed at the balance sheet date. In addition to considering whether ~~it should recognise or change a provision under~~ the evidence affects the measurement of the non-financial liability recognised in accordance with IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~, an entity updates its disclosures about the ~~contingent~~ non-financial liability in the light of that evidence.

22 The following are examples of non-adjusting events after the balance sheet date that would generally result in disclosure:

…

(i) entering into significant commitments or ~~contingent~~ incurring significant liabilities, for example, by issuing significant guarantees; and

…

A8 In IAS 11 *Construction Contracts*, paragraph 45 is replaced and paragraph 45A is added, as follows.

45 An entity shall disclose the following information about the key estimation uncertainties relating to construction contracts:

(a) a description of the uncertainty; and

(b) an indication of its possible financial effects on amounts recognised for construction contracts and the timing of those effects.

45A Estimation uncertainty may relate to amounts recognised in the financial statements (for example, warranty costs, penalties and expected losses) and amounts that are not recognised (for example, claims not yet accepted by the customer). The entity discloses information to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing.

A9 IAS 12 *Income Taxes* is amended as described below.

Paragraph 88 is replaced and paragraphs 88A and 88B are added, as follows.

88 An entity shall disclose the following information about the key estimation uncertainties relating to taxes:

(a) a description of the uncertainty; and

(b) an indication of its possible financial effects on amounts recognised for taxes and the timing of those effects.

88A Estimation uncertainty may relate to both recognised and unrecognised tax assets and liabilities. The entity discloses information to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing (for example, the effects of unresolved disputes with the taxation authorities).

88B When changes in tax rates or tax laws are substantively enacted after the balance sheet date, an entity discloses the effect of those changes on its current and deferred tax assets and liabilities (see IAS 10 *Events after the Balance Sheet Date*).

In Appendix B, Example 2 is amended as follows.

Example 2 - Deferred Tax Assets and Liabilities

…

In X5, the entity was notified by the relevant authorities that they intend to pursue an action against the entity with respect to sulphur emissions. ~~Although as at December X6 the action had not yet come to court~~ Accordingly, the entity recognised a liability of 700 in X5, ~~being its best estimate of the fine arising from~~ which reflected the likelihood that the entity would be required to pay a fine as a result of the action. Fines are not deductible for tax purposes.

…

A10 IAS 14 *Segment Reporting* is amended as described below.

In paragraph 20, 'provisions' is amended to 'liabilities'.

Paragraph 60 is amended as follows.

60 IAS 1 requires that when items of income and expense are material, their nature and amount shall be disclosed separately. IAS 1 offers a number of examples, including write-downs of inventories and property, plant~~,~~ and equipment, ~~provisions for~~ costs associated with restructurings~~s~~ the activities of an entity, disposals of property, plant~~,~~ and equipment and long-term investments, discontinued operations, litigation settlements, and reversals of ~~provisions~~ non-financial liabilities. Paragraph 59 is not intended to change the classification of any such items or to change the measurement of such items. The disclosure encouraged by that paragraph, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the entity level to the segment level.

A11 In IAS 17 *Leases*, paragraph 34A is added as follows.

34A Lessees shall apply IAS 37 *Non-financial Liabilities* to any operating lease obligation that is onerous. IAS 37 explains when a contract is onerous.

A12 IAS 18 *Revenue* is amended as described below.

In paragraph 16(a), 'provisions' is amended to 'terms'.

Paragraph 36 is replaced and paragraph 36A is added, as follows.

36 An entity shall disclose the following information about the key estimation uncertainties relating to revenue:

(a) a description of the uncertainty; and

(b) an indication of its possible financial effects on amounts recognised for revenue and the timing of those effects.

36A Estimation uncertainty may relate to amounts recognised in the financial statements (for example, when revenue is recognised only to the extent of costs incurred because the outcome of the transaction cannot be estimated reliably) and amounts that are not recognised (for example, claims not yet accepted by the customer). The entity

discloses information to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing.

A13 In IAS 19 *Employee Benefits*, paragraphs 3, 17-19, 32B, 52, 69, 104A and 104C are amended as follows, and paragraph 125 is deleted.[3]

3 The employee benefits to which this Standard applies include those provided:

…

(c) by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation ~~where~~ when the entity has ~~no realistic alternative~~ little, if any, discretion ~~but~~ to avoid paying the employee benefits and the employees can reasonably rely on the entity to pay those benefits. An example of a constructive obligation is ~~where~~ when a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

17 An entity shall recognise the expected cost of profit-sharing and bonus payments ~~under~~ in accordance with paragraph 10 when~~, and only when~~:

(a) the entity has a present legal or constructive obligation to make such payments as a result of past events; and

(b) a reliable estimate of the obligation can be made.

A present obligation exists when~~, and only when,~~ the entity has ~~no realistic alternative but~~ little, if any, discretion to avoid ~~make~~ making the payments.

18 Under some profit-sharing plans, employees receive a share of the profit only if they remain with the entity for a specified period. Such plans create an ~~constructive~~ obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such ~~constructive~~ obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.

19 An entity may have no legal obligation to pay a bonus. Nevertheless, in some cases, an entity has a long-standing practice of paying bonuses. In such cases, the entity ~~has~~ may have a constructive obligation ~~because~~ if the entity has ~~no realistic alternative but~~ little, if any, discretion to avoid paying the bonus and the employees can reasonably rely on the entity to pay the bonus. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.

32B IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities* requires an entity to recognise~~, or~~ and disclose information about~~, certain contingent~~ particular non-financial liabilities. In the context of a multi-employer plan, an ~~contingent~~ additional non-financial liability may arise from, for example~~:~~.

~~(a) actuarial losses relating to other participating entities because each entity that participates in a multi-employer plan shares in the actuarial risks of every other participating entity; or~~

~~(b)~~ any responsibility under the terms of a plan to finance any shortfall in the plan if other entities cease to participate.

52 An entity shall account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices. Informal practices give rise to a constructive obligation ~~where~~ when the entity has ~~no realistic alternative but~~ little, if any, discretion to avoid paying employee benefits and the employees can reasonably rely on the entity to pay those benefits. An example of a constructive obligation is ~~where~~ when a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

69 Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words, they are not vested). Employee service before the

[3] Other amendments to IAS 19 resulting from the amendments to the requirements in IAS 37 for restructuring provisions are included in the Proposed Amendments to IAS 19.

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vesting date gives rise to an ~~constructive~~ obligation because, at each successive balance sheet date, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. In measuring its defined benefit obligation, an entity considers the probability that some employees may not satisfy any vesting requirements. Similarly, although ~~certain~~ some post-employment benefits, for example, post-employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists.

104A When~~, and only when, it is virtually certain that~~ an entity has a right to be reimbursed by another party ~~will reimburse~~ for some or all of the expenditure that will be required to settle a defined benefit obligation, ~~an entity shall~~ it recognises ~~its~~ the ~~right to~~ reimbursement right as an ~~separate~~ asset if the reimbursement right can be measured reliably. The entity shall measure the asset at fair value. In all other respects, an entity shall treat that asset in the same way as plan assets. An entity shall not offset against the defined benefit obligation the amount recognised for the reimbursement right. In the income statement, the expense relating to a defined benefit plan may be presented net of the ~~amount recognised for a~~ income resulting from the reimbursement right.

104C When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. Paragraph 104A deals with such cases: the entity recognises its right to reimbursement under the insurance policy as an ~~separate~~ asset, rather than as a deduction in determining the defined benefit liability recognised ~~under~~ in accordance with paragraph 54; in all other respects, the entity treats that asset in the same way as plan assets. In particular, the defined benefit liability recognised ~~under~~ in accordance with paragraph 54 is increased (reduced) to the extent that net cumulative actuarial gains (losses) on the defined benefit obligation and on the related reimbursement right remain unrecognised ~~under~~ in accordance with paragraphs 92 and 93. Paragraph 120A(f)(iv) requires the entity to

disclose a brief description of the link between the reimbursement right and the related obligation.

A14 In IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, paragraph 11 is amended as follows.

11 Once a government grant is recognised, any related ~~contingent liability or contingent asset~~ non-financial liability is ~~treated~~ recognised in accordance with IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities*.

A15 In IAS 21 *The Effects of Changes in Foreign Exchange Rates*, 'provisions' in paragraph 16 is amended to 'liabilities'.

A16 In IAS 28 *Investments in Associates*, paragraph 40 is amended as follows.

40 In accordance with IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities*, the investor shall disclose details of:

(a) ~~its share of the contingent liabilities~~ any non-financial liability of an associate incurred jointly with other investors that, because of extremely rare circumstances, has not been recognised; and

(b) ~~those contingent liabilities~~ any non-financial liability that arises because the investor is severally liable for all or part of the liabilities of the associate.

A17 No consequential amendments are proposed to IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* because the Board expects to issue in the near future a new Standard, based on ED 7 *Financial Instruments: Disclosures*, that will replace IAS 30.

A18 In IAS 31 *Interests in Joint Ventures*, paragraph 54 is amended as follows.

54 A venturer shall disclose details of the ~~aggregate amount of the~~ following ~~contingent liabilities~~ non-financial liabilities~~, unless the probability of loss is remote,~~ separately from ~~the amount of~~ other ~~contingent liabilities~~ non-financial liabilities:

(a) any ~~contingent liabilities~~ non-financial liability that the venturer has incurred in relation to its interests in joint ventures ~~and its share in each of the contingent liabilities that have been incurred jointly with other venturers~~;

(b) ~~its share of the contingent liabilities~~ any non-financial liability of the joint ventures ~~themselves for which it is contingently liable~~ that they have, because of extremely rare circumstances, not recognised; and

(c) ~~those contingent liabilities~~ any non-financial liability that arises because the venturer is ~~contingently~~ severally liable for the liabilities of the other venturers of a joint venture.

A19 In IAS 32 *Financial Instruments: Disclosure and Presentation*, paragraph 94(b) is amended as follows.

94(b) An entity shall disclose the carrying amount of financial assets it has pledged as collateral for liabilities~~, the carrying amount of financial assets pledged as collateral for contingent liabilities~~ and conditional obligations, and (consistently with paragraphs 60(a) and 63(g)) any ~~material~~ terms and conditions relating to assets pledged as collateral.

A20 IAS 34 *Interim Financial Reporting* is amended as described below.

In the Standard, paragraphs 16 and 17 are amended as follows.

16 An entity shall include the following information, as a minimum, in the notes to its interim financial statements, ~~if material and~~ if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis. However, the entity shall also disclose any events or transactions that are material to an understanding of the current interim period:

…

(j) changes ~~in contingent liabilities or contingent assets~~ since the last annual balance sheet date in any unrecognised non-financial liabilities.

17 Examples of the kinds of disclosures that are required by paragraph 16 are set out below. Individual Standards and Interpretations provide guidance regarding disclosures for many of these items:

…

(c) ~~the reversal of any provisions for the costs of restructuring;~~ [deleted]

…

In Appendix B, the heading above paragraph B3, and paragraphs B3, B4 and B6 are amended as follows.

~~Provisions~~ Non-financial liabilities

B3 A ~~provision~~ non-financial liability is recognised when ~~an entity has no realistic alternative but to make a transfer of economic benefits as a result of an event that has created a legal or constructive obligation~~ the definition of a liability has been satisfied and the non-financial liability can be measured reliably. The carrying amount of the ~~obligation~~ non-financial liability is adjusted ~~upward or downward, with a corresponding loss or gain recognised in the income statement, if the entity's best estimate of the amount of the obligation changes~~ subsequently to reflect the current amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party.

B4 This Standard requires ~~that~~ an entity to apply the same criteria for recognising and measuring a ~~provision~~ non-financial liability at an interim date as it would at the end of its financial year. The existence or non-existence of an obligation to transfer benefits is not a function of the length of the reporting period. It is a question of fact.

B6 A bonus is anticipated for interim reporting purposes ~~if, and~~ only if~~,~~ (a) the bonus is a legal obligation or past practice would make the bonus

a constructive obligation ~~for which~~ that the entity has ~~no realistic alternative but to make the payments~~ little, if any, discretion to avoid paying, and (b) a reliable estimate of the obligation can be made. IAS 19 *Employee Benefits* provides guidance.

In Appendix C, paragraphs C3 and C6 are amended as follows.

C3 **~~Provisions~~ Non-financial liabilities:** Determination of the appropriate amount of a ~~provision~~ non-financial liability (such as a ~~provision~~ liability for warranties, environmental costs, and site restoration costs) may be complex and often costly and time-consuming. Entities sometimes engage outside experts to assist in the annual calculations. Making similar estimates at interim dates often entails updating ~~of~~ the prior annual ~~provision~~ liability rather than ~~the~~ engaging ~~of~~ outside experts to do a new calculation.

C6 **Contingencies:** The measurement of ~~contingencies~~ some liabilities (and assets) is required to reflect uncertainty about the occurrence or non-occurrence of one or more related uncertain future events. Therefore, it may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to ~~contingencies~~ these liabilities (and assets). Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may ~~or may not~~ also be needed at interim dates.

A21 IAS 36 *Impairment of Assets* is amended as described below.

In paragraph 43(b), 'provisions' is amended to 'non-financial liabilities'.

Paragraphs 44-47 are amended as follows.

44 Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring ~~to~~ for which ~~an entity is not yet committed~~ a liability has not been incurred; or

…

45 Because future cash flows are estimated for the asset in its current condition, value in use does not reflect:

(a) future cash outflows or related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future restructuring ~~to~~ for which ~~an entity is not yet committed~~ a liability has not been incurred; or

…

46 ~~A restructuring is a programme that is planned and controlled by management and materially changes either the scope of the business undertaken by an entity or the manner in which the business is conducted.~~ IAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities* ~~contains guidance clarifying when an entity is committed to~~ specifies when an entity recognises a liability for a cost associated with a restructuring.

47 When an entity ~~becomes committed to~~ incurs a liability for a cost associated with a restructuring, some assets are likely to be affected by this restructuring. Once the entity ~~is committed to~~ incurs a liability for a cost associated with the restructuring:

(a) its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts approved by management); and

(b) its estimates of future cash outflows for the cost associated with the restructuring are ~~included~~ reflected in the measurement of a ~~restructuring provision~~ non-financial liability in accordance with IAS 37.

Illustrative Example 5 illustrates the effect of a future restructuring on a value in use calculation.

The example following paragraph 78 is amended as follows.

Example

A company operates a mine in a country ~~where~~ in which legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A ~~provision~~ non-financial liability for the ~~costs~~ obligation to replace the overburden was recognised as soon as the overburden was removed. The amount ~~provided was recognised~~ of the liability initially recognised was included as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the ~~provision~~ liability for restoration costs is CU500~~,~~* ~~which is equal to the present value of the restoration costs~~.

The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around CU800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately CU1,200, excluding restoration costs. The carrying amount of the mine is CU1,000.

The cash-generating unit's fair value less costs to sell is CU800. This amount considers restoration costs ~~that have~~ for which a liability has already been ~~provided for~~ recognised. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be CU700 (CU1,200 less CU500). The carrying amount of the cash-generating unit is CU500, which is the carrying amount of the mine (CU1,000) less the carrying amount of the ~~provision~~ liability for restoration costs (CU500). Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount.

* In this Standard, monetary amounts are denominated in 'currency units' (CU).

In paragraph 79, 'other provisions' is amended to 'liabilities'.

In the Illustrative Examples, Example 5 is amended as follows.

Example 5 Treatment of a future restructuring

In this example, tax effects are ignored.

Background

…

IE46 Management-approved budgets reflect that:

(a) at the end of 20X3, the number of employees at the plant will be ~~restructured~~ reduced at an estimated cost (for termination benefits) of CU100. ~~Since~~ Because K ~~is not yet committed to the restructuring~~ has not yet incurred a liability to provide termination benefits, a ~~provision~~ liability has not been recognised at the end of 20X0 ~~for the future restructuring costs~~.

(b) there will be future benefits from this restructuring in the form of reduced future cash outflows.

IE47 At the end of 20X2, K ~~becomes committed to the restructuring~~ recognises a liability to provide termination benefits in accordance with IAS 19 *Employee Benefits*. The costs are still estimated to be CU100 ~~and a provision is recognised accordingly~~. The plant's estimated future cash flows reflected in the most recent management-approved budgets are ~~given~~ set out in paragraph IE51 and ~~a~~ the current discount rate is the same as at the end of 20X0.

IE48 At the end of 20X3, actual ~~restructuring~~ termination benefit costs of CU100 are ~~incurred and~~ paid. Again, the plant's estimated future cash flows reflected in the most recent management-approved budgets and a current discount rate are the same as those estimated at the end of 20X2.

At the end of 20X0

Schedule 1. Calculation of the plant's value in use at the end of 20X0

Year	*Future cash flows*	*Discounted at 14%*
	CU	CU
20X1	300	263
20X2	280	215
20X3	420 [1]	283
20X4	520 [2]	308
20X5	350 [2]	182
20X6	420 [2]	191
20X7	480 [2]	192
20X8	480 [2]	168
20X9	460 [2]	141
20X10	400 [2]	108
Value in use		2,051

1 Excludes estimated ~~restructuring~~ costs of termination benefits reflected in management budgets.

2 Excludes estimated benefits reflected in management budgets expected from the ~~restructuring reflected in management budgets~~ reduction in the number of employees.

…

At the end of 20X2

IE51 The entity ~~is now committed to the restructuring~~ has now incurred a liability to provide termination benefits. Therefore, in determining the plant's value in use, the benefits expected from the restructuring are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. In accordance with paragraphs 110 and 111 of IAS 36, the recoverable amount of the plant is re-determined at the end of 20X2.

Schedule 3. Calculation of the plant's value in use at the end of 20X2

Year	*Future cash flows*	*Discounted at 14%*
	CU	CU
20X3	420 [1]	368
20X4	570 [2]	439
20X5	380 [2]	256
20X6	450 [2]	266
20X7	510 [2]	265
20X8	510 [2]	232
20X9	480 [2]	192
20X10	410 [2]	144
Value in use		2,162

1 Excludes estimated ~~restructuring~~ costs of termination benefits because a liability has ~~already~~ been recognised.

2 Includes estimated benefits reflected in management budgets expected from the ~~restructuring reflected in management budgets~~ reduction in the number of employees.

…

At the end of 20X3

IE53 There is a cash outflow of CU100 when the ~~restructuring costs~~ termination benefits are paid. Even though a cash outflow has taken place, there is no change in the estimated future cash flows used to determine value in use at the end of 20X2. Therefore, the plant's recoverable amount is not calculated at the end of 20X3.

…

A22 IAS 38 *Intangible Assets* is amended as described below.

After paragraph 17 a new heading and paragraphs 17A and 17B are added, as follows.

Contingencies

17A In some cases, an entity has an intangible asset even though the amount of the future economic benefits embodied in that asset is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In such cases, an entity has two rights as a result of a past event, an unconditional right and a conditional right. The intangible asset arises from the unconditional right, but the conditional right is reflected in the measurement of the intangible asset.

17B An example of such an intangible asset is a product warranty. The entity's asset arises from its unconditional right to warranty coverage for the duration of the warranty contract rather than from its conditional right to have its product repaired or replaced if it develops a fault. Similarly, an entity that is pursuing a legal claim has an intangible asset arising from the actions it performed to get to the point of pursuing its claim. Any amounts that the entity expects to receive as a result of pursuing a legal claim are a conditional right, because the right to receive them is conditional on a future event (eg the judgement of the court).

A23 IAS 39 *Financial Instruments: Recognition and Measurement* is amended as described below.

Paragraph 2 is amended as follows.

2 This Standard shall be applied by all entities to all types of financial instruments except:

…

(h) except as described in paragraph 4, loan commitments that cannot be settled net in cash or another financial instrument. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction). An issuer of a commitment to provide a loan at a below-market interest rate shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised ~~under~~ in accordance with IAS 37 *Non-financial Liabilities* and (ii) the amount initially recognised less, ~~where~~ when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. An issuer of loan commitments shall apply IAS 37 to other loan commitments that are not within the scope of this Standard if they are onerous. (IAS 37 explains when a contract is onerous.) Loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 15-42 and Appendix A paragraphs AG36-AG63).

…

(j) rights to payments to reimburse the entity for ~~expenditure it is~~ some or all of the economic benefits that will be required to ~~make to~~ settle a non-financial liability ~~that it recognises as a provision~~ recognised in accordance with IAS 37 *~~Provisions, Contingent Liabilities and Contingent Assets~~*, or for which, in an earlier period, ~~it~~ the entity recognised a ~~provision~~ non-financial liability in accordance with IAS 37.

In the Application Guidance, paragraph AG86 is amended as follows.

AG86 The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss ~~equal to the best estimate within~~ that reflects the range of possible outcomes weighted by their associated probabilities* taking into account all relevant information about conditions existing at the balance sheet date that is available before the financial statements are issued ~~about conditions existing at the balance sheet date~~.

* Example 17 in IAS 37~~, paragraph 39~~ contains guidance on how to determine ~~the best~~ an estimate ~~in~~ when there is a range of possible outcomes.

A24 In IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, paragraph 3 is amended as follows.

3 This Interpretation addresses how the effect of the following events that change the measurement of an existing decommissioning, restoration or similar liability should be accounted for:

…

(b) a change in the current market-based discount rate as ~~defined~~ described in paragraph ~~47~~ 38 of IAS 37 (this includes changes in the time value of money and the risks specific to the liability); and

…

A25 In IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*, paragraphs 9, 10, 12 and 13 are amended as follows.

9 If a contributor does not have control, joint control or significant influence over the fund, the contributor shall recognise the right to receive reimbursement from the fund as a reimbursement right in accordance with IAS 37. This reimbursement right shall be measured at the lower of:

…

10 When a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor or if the value of the investment assets held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations, this obligation is ~~a contingent liability that is~~ within the scope of IAS 37. Therefore, ~~T~~the contributor shall recognise a liability ~~only if it is probable that additional contributions will be made~~ unless it cannot be measured reliably. The measurement of the liability reflects the probability that the contributor

will have to make additional contributions and their amount and timing.

12 When a contributor has an obligation to make potential additional contributions ~~that is not recognised as a liability~~ (see paragraph 10), it shall make the disclosures required by paragraph~~s~~ ~~86~~ 67 and 68 of IAS 37, unless the liability cannot be measured reliably, in which case it shall make the disclosures required by paragraph 69 of IAS 37.

13 When a contributor accounts for its interest in the fund in accordance with paragraph 9, it shall make the disclosures required by paragraph ~~85(c)~~ 68(d) of IAS 37.

Contents

BASIS FOR CONCLUSIONS ON

Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets

IASB Exposure Draft June 2005

BASIS FOR CONCLUSIONS

This Basis for Conclusions accompanies, but is not part of, the draft Standard.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Individual Board members gave greater weight to some factors than to others.

BC2 The amendments to IAS 37 proposed in this Exposure Draft are a result of two of the Board's current projects: the second phase of the Business Combinations project and the Short-term Convergence project. The proposed amendments are principally concerned with the Standard's definitions and recognition criteria, but have also required some more limited amendments to the measurement requirements. The Board has also taken the opportunity to clarify the scope of the Standard and some aspects of the existing measurement requirements.

BC3 The Board's intention was not to reconsider all of the Standard's requirements for accounting for provisions, contingent liabilities and contingent assets. Accordingly, this Basis for Conclusions does not discuss requirements in IAS 37 that the Board has not reconsidered.

Amendments arising from the second phase of the Business Combinations project

BC4 In the second phase of its Business Combinations project, the Board considered the application of the purchase method (now called the 'acquisition method' in the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations*) by an acquirer to the contingencies of an acquiree. As a result, and as detailed below, the Board proposes eliminating the terms 'contingent asset' and 'contingent liability', and proposes a new analysis of items previously described using those terms. These amendments have also required a reconsideration of the application of the probability recognition criterion in IAS 37.

BC5 The Board believes that these proposals simplify the Standard, because with respect to liabilities they require an entity to determine whether the definition of a liability in the *Framework* has been satisfied and, if so, to recognise and measure that liability (unless it cannot be measured reliably). In contrast, IAS 37 has at present three categories of liabilities: (a) possible liabilities, (b) liabilities that are not recognised (because an outflow of economic benefits is not probable or the liability cannot be measured reliably), and (c) liabilities that are recognised (described as provisions).

BC6 The amendments to IAS 37 resulting from these proposals are necessarily extensive. Therefore, the Board decided to present them in this Exposure Draft, rather than as consequential amendments accompanying the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations*.

Contingent assets

BC7 A contingent asset is defined in IAS 37 as a 'possible asset'. A contingent asset arises when it is uncertain whether an entity has an asset at the balance sheet date, but it is expected that some future event will confirm whether the entity has an asset. For example, the Standard explains that an entity pursuing a claim through legal processes (ie a lawsuit), of which the outcome is uncertain, has a contingent asset. Therefore, the lawsuit is not recognised as an asset until it is 'virtually certain' that it will result in the realisation of income and can then be regarded as an asset rather than a possible asset.

BC8 The Board considered this example of a lawsuit in the context of a business combination. The Board observed that a lawsuit of an acquiree would have a fair value and would affect the price that an acquirer would be required to pay for the acquiree. However, if the lawsuit was regarded as a contingent asset at the date of the business combination (because it was not virtually certain to give rise to income), the acquirer would not recognise it as a separate asset but would subsume its value into goodwill.

BC9 The Board noted that in IFRS 3 *Business Combinations* it had concluded that goodwill satisfies the definition of an asset. Given this conclusion, the Board questioned the analysis of a lawsuit in IAS 37. The Board reasoned that if goodwill is an asset, any item subsumed within that goodwill (ie any

item for which the acquirer paid a price, but which itself does not qualify for recognition separately from goodwill in accordance with IAS 38 *Intangible Assets*) must itself also satisfy the definition of an asset in the *Framework*. The Board noted that the lawsuit would be a specific item within goodwill, for which the acquirer would be required to pay, and therefore concluded that it must be an asset and not a possible asset.

BC10 Therefore, the Board reconsidered the analysis of the lawsuit in IAS 37 and, to do so, it turned to tentative decisions it had reached in its Revenue Recognition project, particularly its decisions relating to contractual rights and obligations.

BC11 In its Revenue Recognition project, the Board noted that contractual rights and obligations can be divided into two types: conditional (ie performance is subject to the occurrence of an event that is not certain to occur) and unconditional (ie nothing other than the passage of time is required to make its performance due). The Board also noted that although unconditional contractual rights and obligations may exist on their own, conditional contractual rights and obligations are accompanied by associated unconditional rights and obligations. The Board tentatively concluded that assets and liabilities arising from contracts derive only from *unconditional* (or non-contingent) rights and obligations, and not from conditional (or contingent) rights and obligations. This is because a conditional right to future economic benefits is not a resource controlled by the entity. Similarly, a conditional obligation that may result in an outflow of economic benefits is not a present obligation. However, although a conditional right or obligation in a contract does not itself satisfy the definition of an asset or liability, it points to the existence of an accompanying unconditional right or obligation that may satisfy the definition of an asset or liability.

BC12 This analysis of conditional and unconditional rights and obligations can be illustrated with an example of an entity that has an insurance contract. Some might describe the entity's asset as the possible reimbursement. However, the entity is entitled to reimbursement only if it incurs an insured loss. Therefore, its right to reimbursement is *conditional* (or contingent), because something other than the passage of time is required before the entity can benefit from the reimbursement. Because the right is conditional, it cannot satisfy the definition of an asset in the *Framework*—it is not a *present* right. However, the insurance contract has given the entity

another right, one that is similar to an option on shares of a particular entity. The holder of an option on shares does not own the shares, but the right to buy the shares at a stipulated price and date. The insurance contact grants the entity a similar right, namely the right to insurance coverage, and, as with the rights in an option on shares, this right is *unconditional*. It is the unconditional contractual right to insurance coverage that satisfies the definition of an asset.

BC13 The Board noted that this analysis of an insurance contract highlights that determining whether the entity has an asset (ie an unconditional right) is independent of the probability of the occurrence of the contingency (ie incurring an insured loss). Expressed another way, the contingency does not confirm or establish whether there is an asset, rather it affects the value of the future economic benefits embodied in the asset.

BC14 In its Revenue Recognition project, the Board made its tentative decisions about conditional and unconditional rights and obligations in the context of considering *contractual* rights and obligations. Nonetheless, the Board decided that its analysis of the relationship between conditional and unconditional contractual rights could be applied more widely. In particular, it could be used to refine the analysis of items described in IAS 37 as contingent assets. For example, the Board observed that a lawsuit could be analysed into two rights: the entity's conditional right to compensation (ie conditional upon the outcome of the legal process) and its unconditional right to have its claim for recovery of damages caused by the defendant considered by the courts. In other words, although any compensation that the entity might receive as a result of successfully pursuing its claim is a conditional right, the pursuit of the lawsuit satisfies the definition of an asset.

BC15 The Board concluded that the foregoing would be a better analysis of the lawsuit than that provided by IAS 37. This is because by analysing transactions into unconditional and conditional rights, it is possible to identify the underlying asset better. In other words, it facilitates addressing the question of whether the entity controls a resource at the reporting date and, hence, has satisfied the definition of an asset. In contrast, an entity applying IAS 37 considers the possible inflow of economic benefits (ie the conditional right) and applies a 'virtually certain' probability recognition criterion to determine when those possible benefits have given rise to an asset. However, as noted above, a conditional right does not give rise to

an asset and, therefore, regardless of the probability of an inflow of benefits, should not be recognised.

BC16 The Board considered some other examples of contingent assets. Two examples are an entity that has applied for an operating licence and an entity that is negotiating a significant contract with a customer with whom it has had no prior contractual relationship. In these two examples, the Board concluded that the operating licence and the contract are conditional rights. This is because the rights are conditional (or contingent) on a future event (ie decision of the awarding authority or the customer signing the contract). However, in both cases the entity has an asset. In the case of the licence application, the asset arises from the entity's unconditional right to participate in the process of bidding for the licence. In the case of a pending customer contract, the asset arises from the entity's unconditional right to the economic value of the developing contractual relationship.

BC17 As a result of analysing items previously described as contingent assets into conditional and unconditional rights, the Board decided to eliminate the term 'contingent asset'. The Board concluded that the term was troublesome and confusing. As already noted, assets arise only from unconditional (ie non-contingent) rights. Hence, an asset, which embodies an unconditional right, cannot be described as contingent or conditional. Furthermore, because conditional or contingent rights do not by themselves give rise to assets, it is inconsistent with the *Framework* to recognise them, even if it is virtually certain that they will become unconditional or non-contingent. Therefore, instead of using the term 'contingent' to refer to uncertainty about whether an asset exists, the Board decided that the term should refer to one or more uncertain future events, the occurrence (or non-occurrence) of which affects the amount of the future economic benefits embodied in an asset.

BC18 The Board also decided that it would be more logical to include in IAS 38 the discussion about assets with contingencies. This is because such an asset would be a non-monetary asset without physical form. Hence, if it is *identifiable* (ie if it is separable or arises from contractual or other legal rights) it would, by definition, be an intangible asset. The Board acknowledged that if an intangible asset arising from an unconditional right accompanied by a conditional right is within the scope of IAS 38 and has not been acquired in a transaction, the requirements of IAS 38 impose a

high recognition threshold. (If acquired in a business combination or otherwise, the intangible asset is recognised at fair value. Therefore, uncertainty about the conditional right is reflected in the measurement of the asset.) However, the Board decided that it was outside the scope of this project to revisit the requirements in IAS 38.

Contingent liabilities

BC19 The Board then considered contingent liabilities. The Board observed that in contrast to the definition of a contingent asset, the present definition of a contingent liability includes two notions. The first notion, a possible obligation, is symmetrical with the definition of a contingent asset and arises when the existence of a present obligation at the balance sheet date is uncertain, but some future event will confirm whether the entity has that obligation. The second notion, an unrecognised present obligation, arises when the entity has a present obligation, but that obligation is not recognised as a liability, because either an outflow of economic resources to settle the obligation is not probable or the entity is not able to measure the obligation reliably.

Possible obligations

BC20 The Board had previously considered such obligations in the context of a business combination. In IFRS 3, it specified that an acquirer should recognise at the acquisition date the acquiree's contingent liabilities—and hence its possible obligations—if their fair values could be measured reliably.

BC21 In arriving at this requirement in IFRS 3, the Board took the view that the existence of possible obligations in an acquiree point to the existence of present obligations and, therefore, if their fair value could be measured reliably, the possible obligations should be recognised as liabilities. Furthermore, the Board concluded that it was appropriate that an acquiree's possible obligations should be recognised as liabilities as part of the process of allocating the cost of the business combination, because they have the effect of reducing the price that an acquirer is prepared to pay for the acquiree. In effect, the acquirer is paid to assume an obligation by paying a reduced purchase price for the acquiree.

BC22 In the light of its observations about unconditional and conditional rights and obligations and its conclusions about contingent assets described above, the Board decided that it could refine its conclusions in IFRS 3. It reasoned that its revised analysis of items previously described as contingent assets was also applicable to items previously described as contingent liabilities (possible obligations). The Board also noted that if it refined the analysis of items described as contingent liabilities in IAS 37, there would be no need to specify different requirements for such items in a business combination. Furthermore, all such items would be treated consistently, regardless of whether they are acquired in a business combination or generated internally (subject to the different measurement requirements of IAS 37 and the revised IFRS 3).

BC23 Accordingly, the Board decided to eliminate the term 'contingent liability'. Instead of using 'contingent' to refer to uncertainty about whether a liability exists, the Board decided that the term should refer to one or more uncertain future events, the occurrence (or non-occurrence) of which affects the amount that will be required to settle an obligation.

BC24 These conclusions mean that, for example, an entity that issues a product warranty has a liability arising from its unconditional obligation to provide warranty coverage over the term of the warranty (ie to provide a service). Uncertainty about whether the product will develop a fault, and hence require repair or replacement (ie the contingency), relates to whether the entity's conditional obligation to repair or replace the product if it develops a fault will become unconditional. (The entity's obligation to repair or replace the product is conditional because it depends on whether the product develops a fault.) Hence, the contingency does not determine whether the entity has a liability to provide warranty coverage. Rather, it affects the amount that will be required to settle the obligation. Similarly, in the case of an entity defending a lawsuit, the entity has a liability arising from its unconditional obligation to perform as directed by the courts. The contingency relates to the entity's conditional obligation to pay any penalties imposed by the court and affects the amount that will be required to settle the liability.

BC25 The Board's conclusions about the nature of the unconditional obligation in a warranty contract are consistent with the conclusions of the US Financial Accounting Standards Board (FASB) in Interpretation No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), although the recognition and measurement requirements of FIN 45 do not apply to product warranties issued by an entity. FIN 45 describes the unconditional obligation as an 'obligation to stand ready to perform over the [contract] term'. Whilst the notion of an obligation to stand ready is derived from FASB Concepts Statement No. 6 *Elements of Financial Statements* (Concepts Statement 6), the Board decided to introduce the term into IAS 37 because it regards it as a helpful way of capturing the nature of the liability.

BC26 The Board acknowledged that its analysis of unconditional and conditional rights and obligations may appear complex and that some constituents may already have regarded some examples of liabilities arising from unconditional obligations accompanied by conditional obligations (eg product warranties) as examples of liabilities. Indeed, the Board noted that many financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* could be analysed as containing both a conditional and unconditional obligation. However, as noted with assets, the objective of analysing transactions into unconditional and conditional obligations is to assist in identifying precisely the liability in existence at the balance sheet date, rather than relying on an assessment of some uncertain future event to determine whether a liability exists at that date. The Board concluded that if the liability is identified and accounted for, there is no need to identify the two obligations. Nonetheless, the Board observed that in practice the conditional obligation is sometimes the more readily identifiable obligation. Thus it can be used as a pointer to any associated unconditional obligation. Furthermore, the Board noted that it can be important to distinguish between the two obligations because, as discussed below, the probability recognition criterion in the *Framework* should be applied to the liability (ie unconditional obligation) rather than to the conditional obligation.

BC27 The main difference between the approach in the draft Standard to items previously described as contingent liabilities and that in the current version of IFRS 3 is that an entity is required to determine whether it has a present obligation that satisfies the definition of a liability before considering recognition and measurement. Put another way, the draft Standard does not use either recognition or measurement as a means of resolving uncertainty about whether a liability *exists*. As discussed in paragraph BC41 below, this is consistent with the *Framework*. In contrast, in the

current version of IFRS 3, the contingent liability itself is recognised, and the measurement of the contingent liability reflects the uncertainty about whether the contingent liability had given rise to a present obligation. Therefore, the approach in the draft Standard places greater emphasis on determining whether the definition of a liability has been satisfied and does not allow recognition of possible liabilities. This is consistent with the overall objective of the second phase of the Business Combinations project in which an acquirer recognises the assets acquired and liabilities assumed at the date control is obtained. The Board also noted that the approach is consistent with recent standards of the FASB on liabilities that have adopted a fair value measurement basis. For example, both Statement No. 143 *Accounting for Asset Retirement Obligations* (SFAS 143) and Statement No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146) prohibit the recognition of obligations that do not satisfy the definition of a liability in Concepts Statement 6.

BC28 However, although the proposed approach is different from that in IFRS 3, the Board emphasises that its proposals should not be regarded as a reversal of the requirement in IFRS 3 to recognise contingent liabilities. Rather, they should be viewed as a refinement of that earlier decision. Indeed, the Board observed that in most cases there would be no change in obligations recognised in accordance with the existing and proposed revised versions of IFRS 3. This is because some obligations previously described as contingent liabilities were, in fact, unrecognised *liabilities* and, therefore, will be recognised in a business combination in accordance with the proposed revised IFRS 3. In addition, in many cases, items previously described as possible obligations will be analysed more precisely into two obligations: an unconditional obligation and a conditional obligation. The effect of recognising the liability resulting from the unconditional obligation at fair value in accordance with the proposed revised IFRS 3 would be similar to recognising the contingent liability at fair value in accordance with the existing version. This is because the measurement of the liability will reflect the uncertainty about the conditional obligation.

BC29 Nonetheless, the Board observed that not all items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because some such items contain only a conditional (or contingent) obligation and no unconditional obligation. Therefore, an item that might have been recognised in accordance with the current version of IFRS 3 will no longer qualify for recognition in accordance with the draft Standard or

revised version of IFRS 3. For example, the Board considered a scenario in which an entity would be required to take back previously sold products for disposal if a new law were passed (in other words, the new law would have a retrospective effect). The Board noted that until the new law is substantively enacted, the entity would have no present unconditional obligation (unless the entity by its own actions created a constructive obligation before the law was enacted). Hence, the entity would have only a conditional obligation to take back products and, therefore, no liability. Expressed another way, the Board concluded that an entity does not have a stand ready obligation with respect to a possible change in the law. This is because it is the new law that creates new obligations and until the law is substantively enacted those obligations do not exist. Accordingly, an entity cannot have a present obligation with respect to that law.

Unrecognised present obligations

BC30 Having decided to eliminate the term 'contingent liability', the Board considered the notion of an unrecognised present obligation in IAS 37, which is also described as a contingent liability. As noted above, liabilities arise only from unconditional obligations. Hence, something that is a present obligation cannot be described as being contingent. The Board also noted that there was no need to define liabilities that fail to qualify for recognition because they can be described as unrecognised liabilities. Therefore, the Board does not propose to define such liabilities. Consistently with the current requirements in IAS 37 for contingent liabilities, liabilities that are not recognised in accordance with the draft Standard are required to be disclosed.

Disclosure of contingent assets and contingent liabilities

BC31 The amendments in the draft Standard relating to contingent assets and contingent liabilities are primarily concerned with correctly identifying the right and obligation (unconditional) and then accounting for that right and obligation. Consistently with those amendments, the Board decided to withdraw the requirement in IAS 37 to disclose contingent assets and contingent liabilities. Therefore, the draft Standard specifies only the disclosures required for liabilities (with or without associated

contingencies), whereas assets with contingencies are disclosed in accordance with other Standards.

BC32 The Board noted that some might feel uncomfortable about this proposal, because it suggests that important information previously associated with contingencies, particularly contingent liabilities, will no longer be disclosed in the financial statements. However, with respect to contingent liabilities, the Board believes that in most cases there will be no loss of disclosure. This is because most items described as being contingent liabilities in IAS 37 will now be viewed as liabilities, with the contingency referring to the conditional obligation that affects the measurement of the liability. Hence, the disclosure required by paragraph 68 for the liability will capture the information previously presented for the contingent liability. In particular, an entity will be required to give an indication of the uncertainties about the amount or timing of the outflow of economic benefits. The Board concluded that those items described as contingent liabilities in IAS 37 that do not contain unconditional obligations are business risks. Hence, discussion about such items would typically be included in any financial review by management accompanying the financial statements. The Board also noted that the effects of such items would often be disclosed in accordance with paragraph 116 of IAS 1 *Presentation of Financial Statements*, because they may have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year.

BC33 Other Standards also require disclosure of contingent assets and contingent liabilities. In the cases of IAS 11 *Construction Contracts*, IAS 12 *Income Taxes* and IAS 18 *Revenue*, the Board concluded that the disclosure of contingencies was designed to provide information about measurement uncertainty relating to items accounted for in accordance with those Standards. Therefore, the contingencies referred to in those Standards are unaffected by the proposed amendments to IAS 37. For example, IAS 11 explains that contingencies arise from warranty costs, claims and penalties, ie items that are accounted for in IAS 11 as part of contract revenue and contracts costs.

BC34 Accordingly, in the consequential amendments the Board proposes replacing the requirement in IASs 11, 12 and 18 to disclose contingent assets and liabilities with a requirement to disclose the key measurement uncertainty relating to construction contracts, income taxes and revenue.

BC35 In other Standards, for example IAS 28 *Investments in Associates*, the requirement to disclose contingent liabilities is a reminder of the requirement in IAS 37 to disclose (a) liabilities not recognised in accordance with IAS 37 and (b) possible obligations. In these cases, if the item previously described as a contingent liability is determined to be a liability in accordance with the draft Standard, it will be recognised unless it cannot be measured reliably. Therefore, the Board has amended the requirements to require disclosure of the unrecognised liabilities in accordance with IAS 37.

Probability recognition criterion

BC36 Having refined its analysis of items previously described as contingent liabilities, the Board concluded that it would need to reconsider the probability recognition criterion in IAS 37.

BC37 Paragraph 14(b) of IAS 37 specifies that a provision is recognised 'if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation', 'probable' being defined as 'more likely than not'. The Board noted that in many cases, an entity does not need to make any assessment of the probability of an outflow because there is little or no uncertainty that settlement of the obligation will require *some* outflow of resources embodying economic benefits, even if there is significant uncertainty about the amount or timing of the outflow. An example is an entity that has an obligation to decommission a nuclear power station.

BC38 However, the Board noted that in some other cases application of the probability recognition criterion in IAS 37 was more troublesome. For example, in the case of a guarantee, Example 9 in the Standard explains that a guarantor applies the criterion by considering the probability of having to make a payment under the guarantee. This means that if the guarantee is issued in exchange for a fee, and it is not probable that a payment will be required under the guarantee, the guarantor does not recognise a liability. In the absence of the revenue recognition requirements of IAS 18, the entity would recognise a gain. This accounting is counter-intuitive, because an entity that has been paid to assume an obligation would recognise a gain on initial recognition, followed by losses if payments under the guarantee are made.

BC39 The Board acknowledged that in practice many guarantees within the scope of IAS 37 would be recognised because the Standard requires entities to consider recognition by reference to a portfolio (or class) of similar obligations. Thus, although it might not be probable that a payment will arise from a single guarantee, it is probable that *some* payment will arise in a portfolio of guarantees and, therefore, a liability is recognised. However, the Board decided that resolving a troublesome recognition issue in this way (ie by requiring recognition on a portfolio basis) is conceptually unsatisfactory. It would be better if the probability recognition criterion could be applied consistently for single guarantees and portfolios of guarantees.

BC40 Having analysed the obligations in transactions such as guarantees and warranties into conditional and unconditional obligations, the Board observed that the probability recognition criterion in IAS 37 is sometimes applied to the 'wrong' obligation. This is because it is applied to the conditional obligation (ie the contingency) rather than the unconditional obligation (ie the contractual stand ready service obligation). For example, in the case of a guarantee, it is applied to the guarantor's conditional obligation to make a payment under the guarantee. Similarly, in the example of a product warranty (Example 1 in the Standard), the criterion is applied to the entity's conditional obligation to repair or replace the product.

BC41 The Board concluded that applying the probability recognition criterion to the conditional obligation conflicted with the *Framework*. This is because paragraph 82 of the *Framework* describes recognition as 'the process of incorporating in the balance sheet or income statement an item *that meets the definition of an element*' (emphasis added). In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. As explained in paragraph BC24, in the case of a guarantee or a product warranty, the liability that is being considered for recognition is the unconditional obligation to stand ready to provide a service over the period of the guarantee or the product warranty. It is not the conditional obligation to make a payment under the guarantee or to repair or replace the product. Hence, the question is whether settlement of the present obligation (ie the unconditional obligation) to provide a service will probably result in an outflow of economic benefits, and not whether the conditional obligation to make a payment or to repair the product will probably result in an outflow of resources.

BC42 The *Framework* articulates the probability recognition criterion in terms of a flow of economic benefits. It also explains that the outflow required to settle a liability can occur in various ways. In particular, it explains that the outflow of resources can be the provision of services. The Board reasoned that because an entity that issues a guarantee or a product warranty has an obligation to provide a service—because it is contractually obliged to honour claims—the outflow of resources that is required to settle this obligation should be regarded as the provision of services over the term of the contract, and not the possible payments under the guarantee or product warranty.

BC43 Viewing the outflow of resources as the provision of services means that an entity that issues a guarantee or a product warranty satisfies the probability recognition criterion by definition. This is because it is certain that the stand ready obligation would require an outflow of resources in settlement. The assessment of the probability of an outflow of resources is independent of the likelihood of a claim arising under the guarantee or product warranty. In other words, even if it is highly unlikely that a claim will arise, the probability recognition criterion is still satisfied. As noted above, the probability of a claim arising relates to the likelihood of the *conditional* obligation becoming a present obligation. Accordingly, the Board concluded that the probability of a payment or claim arising under a guarantee or warranty should not determine whether the entity's *present* obligation to provide a service should be recognised. Rather, the likelihood of claims arising should be reflected in the measurement of that present obligation.

BC44 The Board's conclusions about the application of the probability recognition criterion in the case of warranties and guarantees are consistent with FIN 45. This Interpretation explains that a guarantor has incurred a liability on issuing a guarantee that qualifies for recognition, even if it is not probable that the specified triggering events or conditions that would cause payments under the guarantee will occur. The FASB concluded that the outflow of resources associated with the unconditional obligation to stand ready to perform over the term of the guarantee is the requirement to 'stand ready to provide services' and not the possible payments required under the guarantee.

BC45 The Board observed that its analysis of the application of the probability recognition criterion to a guarantee or product warranty could be extended

to any liability arising from an unconditional contractual obligation accompanied by a conditional obligation. This is because such liabilities arise from the contractual obligation to stand ready to provide a service. For example, an entity that is jointly and severally liable with another entity, but expects that other entity to be responsible for the obligation, is providing a service to the counterparty because the counterparty has the right to look to the entity to honour the obligation (ie the entity is standing ready to honour the obligation). Similarly, a retailer that is obliged, contractually or constructively, to offer refunds to dissatisfied customers is providing a service to its customers because those customers have a right to return their products (ie the retailer is standing ready to accept returns).

BC46 The Board then considered liabilities that accompany non-contractual contingent liabilities. As noted above, the Board decided that the relationship between conditional and unconditional contractual obligations could be extended to non-contractual obligations. For example, in the case of a lawsuit, the Board observed that although the penalties that a defending entity might be required to pay are a conditional obligation, the entity has no discretion to do otherwise than perform as directed by the court. Therefore, the Board concluded that the entity also has a present (ie unconditional) legal obligation, namely an obligation to stand ready to pay any penalties awarded by the court. Because the outflow of resources is the standing ready (ie the provision of a service), rather than the possible damages, the Board concluded that the probability recognition criterion is satisfied. It is certain that the entity is obliged to accept any obligation imposed by the court. In effect, the court's ability to impose settlement stands in the place of a contract.

BC47 The Board observed that the above conclusions about the application of the probability recognition criterion mean that in practice the criterion would have no effect in determining whether a liability should be recognised, because in all cases in which an unconditional obligation exists the criterion would be satisfied. Therefore, the Board considered whether it should retain the probability recognition criterion in the Standard. The Board noted that the criterion might be misapplied in some situations. In particular, it might be applied to the entity's conditional obligation rather than to its present obligation, in cases in which an entity has two obligations, with the result that liabilities are not recognised. The Board also noted that there is anecdotal evidence to suggest that some use the criterion to determine whether they have incurred a liability, instead of

determining whether the definition of a liability has been satisfied. This could result in an entity that has a conditional obligation with a very high probability of an outflow of economic benefits concluding that it should recognise a liability. However, if the definition of a liability is not satisfied (in particular, if there is no present obligation), the entity should not recognise a liability. Similarly, relying on the probability recognition criterion to determine whether a constructive obligation exists could result in the recognition of items that are not liabilities. This is because in some cases an entity may conclude that there will probably be an outflow of economic benefits, even though it has no *obligation* to incur that outflow. Lastly, the Board noted that it would add unnecessary complexity to the Standard to specify a criterion that is always satisfied. Therefore, the Board decided to omit the criterion from the draft Standard.

BC48 The Board acknowledged that the criterion is derived from the *Framework* and, therefore, not including the criterion in the Standard might give the impression of inconsistency with the *Framework*. Indeed, the Board was aware that many of its constituents regard some of its recent Standards as inconsistent with the *Framework* because they do not contain a probability recognition criterion. However, the Board concluded that there would be no inconsistency. The apparent inconsistency arises only if the conditional or contingent obligation is being considered rather than the unconditional obligation. Having refined the analysis of liabilities in IAS 37 to focus on the unconditional obligation, the Board concluded that it was inevitable that the current interpretation of the probability recognition criterion in IAS 37 would need to be reconsidered. Nonetheless, the revised interpretation is consistent with the *Framework*. Furthermore, it results in consistent recognition of contractual obligations in accordance with IAS 37 and IAS 39, because the probability recognition criterion in the *Framework* is being applied in the same way in both Standards. For example, in considering the recognition of an option in accordance with IAS 39, an entity does not consider whether it is probable that the option will be exercised. Rather, the probability recognition criterion is applied to the unconditional obligation.

Amendments arising from Short-term Convergence project

BC49 In September 2002 the Board decided to add a Short-term Convergence project to its active agenda. The objective of the project is to reduce

differences between IFRSs and US generally accepted accounting principles (US GAAP) that are capable of resolution in a relatively short time and can be addressed outside current and planned major projects. The project is a joint project with the FASB.

BC50 In working towards the objective of the project, the two boards agreed to review each other's deliberations on each of the selected possible convergence topics and choose the higher quality solution as the basis for convergence. For topics recently considered by either board, there is an expectation that whichever board had more recently deliberated that topic would have the higher quality solution.

BC51 As part of the review of topics recently considered by the FASB, the Board considered the requirements of SFAS 146, which was issued in June 2002.

BC52 SFAS 146 nullifies EITF Issue No. 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* (Issue 94-3). Because Issue 94-3 contained recognition guidance similar to that in IAS 37, the Board noted that the introduction of SFAS 146 would lead to differences in the timing of recognition of liabilities for restructuring costs (a point acknowledged by the FASB in its Basis for Conclusions on SFAS 146). In particular, the Board observed that liabilities for the same restructuring costs would, in many cases, be recognised at an earlier point under IFRSs than under US GAAP (perhaps significantly so). Furthermore, the Board was concerned that the present guidance for the recognition of restructuring provisions in IAS 37 (paragraphs 70-83) could result in the recognition of items that do not satisfy the definition of a liability in the *Framework*.

BC53 The Board concluded that converging with the recognition requirements of SFAS 146 would allow the accounting for similar events and circumstances to be the same, thereby improving the comparability and representational faithfulness of financial information. As a result (and as discussed in detail below), the Board proposes:

(a) amending the definition of a constructive obligation and providing additional guidance to assist in determining whether such an obligation exists;

(b) adding an additional recognition criterion for some liabilities for onerous contracts; and

(c) substantially revising the requirements for liabilities for costs associated with a restructuring.

Definition of constructive obligation

BC54 The Board noted that the principle underlying SFAS 146 is that a liability for a cost associated with an exit or disposal activity (which includes, but is not limited to, a restructuring as defined by IAS 37) is recognised when incurred, ie when the entity has a present obligation. This is similar to the principle in IAS 37 that a provision is recognised when the entity has a present obligation. Nevertheless, in the context of a restructuring, the Board noted that the two standards specify different interpretations of when that present obligation arises. The Board observed that this difference in interpretation arises because the restructuring guidance in IAS 37 is an application of the Standard's notion of a constructive obligation, a notion that is differently understood under US GAAP.

BC55 The Board noted that both the *Framework* and Concepts Statement 6 provide general descriptions of constructive obligations. However, it noted that there is no equivalent in US GAAP of IAS 37's definition of a constructive obligation. Indeed, the Board noted that some regard Concepts Statement 6 as suggesting that not all constructive obligations are liabilities.

BC56 The Board observed that paragraph 40 of Concepts Statement 6 states that although constructive obligations 'lack the legal sanction that characterizes most liabilities', they are 'commonly paid in the same way as legally binding contracts.' In other words, the entity is bound by its obligation to a counterparty (although the FASB acknowledged the difficulty of determining whether an entity is bound by its obligation in the absence of legal enforceability). The Board also considered the three essential characteristics of a liability identified by Concepts Statement 6 and referred to in the Bases for Conclusions on SFAS 143 and SFAS 146. The Board noted that, as with the definition of a constructive obligation in IAS 37, those Statements highlight that a promise, and hence an obligation, can be 'inferred from the entity's past practice, which, absent

evidence to the contrary, others can presume that the entity will continue'.[4] However, the Board noted that for that promise to create an obligation, other parties must be justified in relying on that promise. The Board observed that in both Bases for Conclusions, the FASB gave specific guidance about when a counterparty is justified in relying on the entity's promise, namely that (a) the counterparty must be the recipient of the promise; (b) the counterparty must reasonably expect the entity to perform; and (c) the counterparty will either benefit from the entity's performance or suffer loss or harm from non-performance.

BC57 Having considered the FASB's deliberations, the Board concluded that the threshold for determining whether an entity's past actions have created a constructive obligation is higher in US GAAP than in IAS 37. This is because, in US GAAP, the other parties must be able to rely on the entity's carrying out its promise, whereas in IAS 37 other parties must have a valid expectation that the entity will discharge its responsibilities. Although the notions are similar, the Board concluded that they have different emphases. Furthermore, the Board was concerned that the present definition in IAS 37 could be interpreted to allow recognition of items that lack an essential characteristic of a liability, namely the existence of an *obligation* to others.

BC58 The Board noted that SFAS 143 requires judgement about whether others are justified in relying on the entity to perform as promised to be made using the doctrine of 'promissory estoppel'. This is a legal principle that protects a counterparty's reliance on a promise by enforcing promises that are not supported by consideration and oral promises that ordinarily would be required to be in writing. Accordingly, a constructive obligation is recognised in accordance with SFAS 143 only if that obligation is a legal obligation and could be enforced by a court.

BC59 The Board considered whether it should similarly limit recognition of constructive obligations in IAS 37 to those that a court would enforce. In other words, it considered whether to specify that an entity has incurred a liability only if there is a counterparty that could legally enforce the obligation and require the entity to carry out its promise. The Board concluded that it would be premature to make such an amendment in advance of reconsidering liabilities more generally. Nevertheless, the

[4] Paragraphs B25b and B19a of SFAS 143 and SFAS 146 respectively.

Board concluded that it could emphasise that a constructive obligation involves an *obligation* to others (and hence is not something that an entity can avoid at whim) by introducing into its definition the notion that the counterparty should be reasonably able to rely on the entity to discharge its responsibilities.

BC60 The Board observed that its proposed amendment should not alter existing practice for well-understood examples of constructive obligations (for example, some environmental clean-up obligations and warranty obligations) because in these cases there is usually a counterparty that is relying on the entity to discharge its responsibilities. However, items that were previously determined to be constructive obligations, but leave the entity discretion to avoid settling the item, will no longer be recognised as liabilities.

Recognition of liabilities for onerous contracts

BC61 The Board noted that in US GAAP there are no general requirements for onerous contracts similar to those in IAS 37. However, the Board noted that SFAS 146 provides specific guidance for two classes of contract termination costs that under IFRSs would be likely to be classified as onerous contracts: (a) costs that arise from terminating a contract before the end of its term and (b) costs that will continue to be incurred under a contract for its remaining term without equivalent economic benefit to the entity (for example, an operating lease of a vacant property). The liability for the former is recognised only when the decision to terminate the contract has been communicated to the counterparty and the entity has incurred a legal obligation under the contract for the penalty or other costs specified by the contract. The liability for the latter is recognised when the entity ceases to use the right conveyed by the contract.

BC62 The Board noted that in SFAS 146 the FASB has moved away from an intention-based approach for the recognition of contract termination costs. In contrast, the Board noted that the present requirements in IAS 37 would be likely to result in entities recognising liabilities for these onerous contracts on the basis of a commitment, or an intention, to restructure. This is because IAS 37 requires a liability for an onerous contract to be recognised when the contract is onerous, ie at the point when the 'unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it'. It noted that this

recognition point depends on the entity's expectation of future benefits and would inevitably be open to differing interpretations.

BC63 The Board noted that questions relating to the timing of recognition of a liability for an onerous contract arise because, in some cases, there is no new obligating event that results in the entity incurring a present obligation. For example, in the case of an operating lease that satisfies the definition of an onerous contract, the entity's present obligation was, in fact, incurred when the entity entered into the lease. The entity has incurred no new obligation as a result of the contract becoming onerous. The requirements relating to onerous contracts effectively compensate for the fact that the rights and obligations under executory contracts and operating leases are not recognised under current accounting conventions. Indeed, in the example of an operating lease, the Board noted that the expense on recognising a liability for an onerous contract is similar to an impairment (ie of the unrecognised asset arising under the lease contract).

BC64 The Board concluded that reconsidering the requirements for onerous contracts more generally was outside the scope of this project. The Board also noted that it had two projects on its active and research agendas (Revenue Recognition and Leases, respectively) that could affect the present accounting for leases and executory contracts and, as a consequence, also affect the requirements relating to onerous contracts. Nevertheless, it acknowledged that the present requirements might result in items being recognised as liabilities on the basis of management intent, which would be contrary to the principle of SFAS 146 that the Board was seeking to adopt. Because the Board does not believe that there is a conceptual basis for differentiating onerous contracts that arise within a restructuring plan from those that arise outside such a plan, the Board concluded that it should make a limited amendment to the requirements for onerous contracts generally so as to converge with the specific requirements in SFAS 146 relating to contract termination costs.

BC65 The Board noted that onerous contracts can be divided into two broad categories: those that become onerous because of factors outside the entity's control (for example, a take-or-pay contract in which the market price of the contracted product declines below the contracted price for that product) and those that become onerous because of the entity's own actions (for example, as a result of vacating a property). Therefore, the Board decided to adopt the recognition requirements of SFAS 146 by

specifying that if a contract will become onerous as a result of the entity's own actions, the liability should not be recognised until the entity has taken that action. The Board believes that until the entity has undertaken the action that makes the contract onerous (for example, has exercised its option to terminate the contract or has ceased using the leased asset), the entity has the discretion to change its intended action.

Sublease income

BC66 The Board noted that in SFAS 146, if an entity ceases to use the right conveyed by an operating lease, but does not terminate the lease, the liability is based on the remaining lease rentals, reduced by the estimated sublease rentals that could be reasonably obtained for the property, regardless of whether the entity intends to enter into a sublease. The Board decided that it should provide the same guidance on this point in IAS 37 because it was informed that in practice there is uncertainty surrounding the treatment of sublease income.

BC67 The FASB's requirement is founded upon its fair value measurement objective, because it takes account of the sublease rentals the market would expect the entity to realise. Although the measurement objective of IAS 37 is not specifically fair value, the Board noted that the SFAS 146 requirement is not inconsistent with IAS 37's measurement requirements. This is because a third party would factor market sublease rentals into its measure of the amount it would expect to be paid to relieve the entity of its obligation. The Board also noted that if it specified that the sublease rentals should be those that the entity expects to receive, significant changes in the liability might be recognised subsequently as the entity revises its decision to sublease.

Liabilities for restructuring costs

BC68 The Board observed that the FASB concluded in SFAS 146 that because a restructuring plan merely reflects an entity's intended actions it does not, by itself, create a present obligation and is not the requisite past transaction or event for recognition of a liability. Under IAS 37, a restructuring plan by itself similarly does not give rise to a present obligation. However, in the light of the FASB's decision, the Board considered whether a plan together with its announcement gives rise to a liability by imposing on the entity a constructive obligation to restructure. It

noted the guidance in paragraph 17 of IAS 37 that an obligating event requires the entity to have 'no realistic alternative to settling the obligation' and, therefore, considered whether a restructuring plan and its announcement leave the entity in that position. The Board reasoned that, even if an entity has announced its restructuring plan in a general way, it has no *obligation* to others and is not bound by its plan to the extent that it cannot avoid an outflow of resources. The Board decided that because an entity can recall its restructuring plan once it has been announced, the restructuring guidance in the present version of IAS 37 is a misapplication of the Standard's notion of a constructive obligation.

BC69 Accordingly, the Board decided to withdraw the present guidance for the recognition of restructuring provisions in IAS 37 and state that liabilities arising from costs associated with a restructuring should be recognised on the same basis as if that cost arose independently of a restructuring, namely when the entity incurs a liability that can be measured reliably. Thus, instead of an entity recognising at a specified point a single liability for all of the costs associated with a restructuring, it will recognise liabilities for each cost associated with the restructuring as the liability for each cost is incurred.

BC70 The Board also decided that it should follow the example of SFAS 146 and provide specific guidance for applying the definition of a liability to the following costs that are often associated with a restructuring:

(a) termination benefits

(b) contract termination costs.

Termination benefits

BC71 SFAS 146 specifies the accounting treatment for one-time termination benefits. Concurrently with these proposed amendments to IAS 37, the Board is proposing amendments to the accounting for termination benefits contained in IAS 19 *Employee Benefits*. The purpose of those amendments is also to converge with SFAS 146 (although the Board proposes that the principles underlying SFAS 146 should apply to all termination benefits, not just those that are within the scope of SFAS 146).

Contract termination costs

BC72 The Board noted that if an entity terminates a contract before the end of its term, that contract could become onerous (if not previously determined to be onerous). Similarly, if an entity continues to incur costs under a contract for its remaining term without receiving equivalent economic benefit, that contract would become onerous. Therefore, the Board concluded that it should specify that an entity should apply the requirements relating to onerous contracts in paragraphs 55-59 of the draft Standard for contract termination costs. The Board believes that, having amended the requirements for onerous contracts as described above, it has largely achieved convergence with US GAAP on the accounting for these costs.

Provision for the sale of an operation

BC73 In amending the present guidance for the recognition of restructuring provisions, the Board deleted former paragraph 78, which specified that no obligation arises for the sale of an operation until the entity is committed to the sale. The Board noted that if an entity plans to sell an operation and expects to incur a loss, it should consider recognising an impairment loss in accordance with either IAS 36 *Impairment of Assets* or IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Other amendments

Scope of IAS 37

BC74 IAS 37 defines a provision as 'a liability of uncertain timing or amount'. Therefore, provisions are a subset of liabilities as defined in the *Framework*. However, the Board noted that the Standard contains no clear conceptual rationale for distinguishing a provision from a liability. Because of this, the Board was concerned that a liability that was not within the scope of another Standard might be excluded from the scope of IAS 37 on the basis that there is little uncertainty about the timing or amount of the obligation.

BC75 The Board decided that the recognition and measurement requirements of IAS 37 would be appropriate for all non-financial liabilities not within the scope of other Standards. In arriving at this conclusion, the Board noted

that for an obligation that an entity is paid to assume, IAS 37 requires revenue to be recognised in accordance with IAS 18. This results in the obligation being measured at the higher of (a) the amount specified by IAS 37 and (b) the amount of revenue deferred in accordance with IAS 18. Nonetheless, the Board was concerned that in some cases the cost of providing the disclosures currently required by paragraphs 84 and 85 of IAS 37 might exceed the benefits of providing those disclosures. Therefore, it decided to limit the more extensive disclosure requirements of those paragraphs to liabilities with material estimation uncertainty. Having addressed this point, the Board concluded that, apart from specified exceptions, it could clarify that IAS 37 applies to all non-financial liabilities that are not within the scope of other Standards. It reasoned that the best way of achieving this would be to stop using a special term to define the liabilities within the scope of IAS 37. Thus, the Board proposes not to use 'provision' as a defined term. In its place, the Board proposes describing liabilities within the scope of IAS 37 as 'non-financial liabilities'. The Board is using the phrase 'non-financial' to make a clear distinction between liabilities within the scope of IAS 39 and those within the scope of IAS 37.

BC76 The Board acknowledged that in some jurisdictions, the term 'provision' is well understood to mean a particular subset of liabilities and, therefore, that the decision not to use the term in the draft Standard may cause concern. However, IFRSs do not specify how items should be described in financial statements and, thus, entities may continue to describe some liabilities as provisions in their financial statements. But the Board also understood that in some other jurisdictions the term 'provision' causes confusion. This is either because there is no clear distinction between a liability and a provision, or because 'provision' is used in that jurisdiction to describe an item that would not necessarily satisfy the definition of a liability. In at least one jurisdiction, 'provision' refers to an item in the income statement rather than in the balance sheet; in others it refers to asset valuation allowances.

Measurement

BC77 The Board observed that the FASB has adopted a fair value measurement objective on initial recognition of a liability in some of its recent Statements (including SFAS 146). This is because the FASB believes fair value is the most relevant and faithful representation of the underlying economics of a transaction. IAS 37, on the other hand, requires provisions to be measured at the best estimate of the expenditure required to settle the

present obligation or to transfer it to a third party on the balance sheet date.

BC78 The IAS 37 requirement can be interpreted as being similar to fair value, but the Board acknowledges that the requirement leaves some issues unresolved. The Board concluded that it would be inappropriate to make fundamental changes to the measurement objective of the Standard in this project given the Board's more far-reaching project on the conceptual framework. Nonetheless, the Board noted that it would be awkward to apply some of the present measurement requirements to stand ready obligations (ie unconditional obligations accompanied by conditional obligations). In addition, the Board was concerned that the measurement requirements are not always consistent and can be interpreted in different ways. Therefore, the Board proposes some amendments to these requirements.

Amount that an entity would rationally pay to settle or transfer the obligation

BC79 The Board concluded that the present explanation of best estimate in paragraph 37 of IAS 37 as 'the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time' should be the measurement objective of the Standard. The Board believes that this phrase sets out a clearer principle for measuring liabilities and is less likely to be misinterpreted than the notion of 'best estimate'.

Use of expected cash flow estimation technique

BC80 The Board noted that in some cases, a stand ready service obligation might be separately priced, for example, in the case of some product warranties. However, the Board noted that in many cases there would be no directly observable market price for such obligations, for example in the case of a disputed lawsuit or a warranty included in the price of a product. The Board noted that in such cases an entity would need to use a surrogate for measuring the service obligation. The Board noted that the amount an entity would expect to pay to settle the service obligation (ie stand ready obligation) would reflect the likelihood, amount and timing of the expected cash flows attaching to the conditional obligation. Thus, the

most appropriate way to measure such an obligation is to use an expected cash flow approach.

BC81 However, IAS 37 suggests that using an expected cash flow approach is most appropriate for a large population of items. In contrast, it specifies that 'the individual most likely outcome may be the best estimate of' a single obligation. Hence, if an entity has a 60 per cent chance of losing a court case at a cost of CU1 million and a 40 per cent of winning at no cost, the Standard could be interpreted to require the liability to be measured at CU1 million. The Board, however, observed that measuring a liability at the 'most likely outcome' conflicts with the principle of measuring liabilities at the 'amount that an entity would rationally pay to settle the obligation … or to transfer it to a third party'. The Board reasoned that if management concluded that there was a chance of settlement at no cost, it would not settle the obligation for the maximum amount that might be required. Rather, management would take into consideration the expected value of the potential outcomes. The Board also noted that measuring a liability at its most likely outcome fails to reflect the uncertainty inherent in the obligation. This can therefore result in two obligations with different risks and uncertainties being measured at the same amount.

BC82 Accordingly, the Board decided to emphasise that an expected cash flow approach, which is currently cited as an estimation method that can be used as a basis for measuring liabilities for a large population of items, is also appropriate for single obligations.

Discount rate

BC83 The Board noted that in practice, before IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* was issued, there was some confusion about whether IAS 37 required a current discount rate to be used both on initial recognition and on subsequent measurement. Therefore, in the draft Standard, the Board decided to clarify that when discounting is used, the rate is a current rate at each balance sheet date. The Board acknowledges that in relation to subsequent measurement of a liability this is different from SFAS 143 and SFAS 146. However, the Board believes that the use of a current rate is both more representationally faithful and consistent with the existing requirements of IAS 37.

Future events

BC84 IAS 37 currently specifies that future amounts should be reflected in the measurement of a liability if there is sufficient objective evidence that they will occur. Therefore, for example, in measuring an obligation to clean up environmental contamination, an entity should not anticipate the development of a completely new technology for cleaning up unless that technology is supported by sufficient objective evidence. However, it would be appropriate for the entity to reflect the expected benefits of the effects of increased experience in applying existing technology.

BC85 The Board noted that this requirement conflicts with measuring obligations using an expected cash flow approach. For example, an entity that is measuring a product warranty obligation with no observable market price would consider the likelihood that claims will occur, and the amount and timing of the cash flows that will be required to meet those claims. Read literally, IAS 37 suggests that the likelihood of future claims arising would be reflected in the measurement of a liability only if there is sufficient objective evidence that they would occur. Accordingly, some (possibly all) of the cash flow scenarios that should be considered in measuring the liability might be inappropriately disregarded.

BC86 The Board reasoned that if an expected cash flow approach is used appropriately, there is no reason why an entity should not use assumptions about future events that affect the amount required to settle an obligation, regardless of whether there is 'objective evidence' about those events occurring. This is because in an expected cash flow calculation, the likelihood of those events occurring will be reflected in the probability weighting applied to the cash flows. Thus, for example, an entity measuring a clean-up obligation should make assumptions about future changes in technology, as long as the probability weighting applied to those assumptions appropriately reflects the likelihood that the change in technology will occur.

BC87 Therefore, the Board decided to withdraw the requirement for future events that affect the amount that will be required to settle the obligation to be included in the measurement of that obligation only if there is sufficient objective evidence that they will occur. Although some may be concerned that this could result in unrealistic assumptions being used in the measurement of a liability, the Board noted that the measurement requirement in IAS 37 encompasses a settlement notion. This enforces

discipline in measuring a liability because an entity is required to consider what a counterparty would demand to assume the liability.

BC88 The Board also decided to amend former paragraph 50 to specify that the effect of possible new legislation should not be reflected in the measurement of a liability. The Board reasoned that if, as discussed in paragraph BC29, there is no obligation until the law is substantively enacted (ie until the new law exists), it would be inconsistent to measure an *existing* obligation taking into account a possible change in the law. Accordingly, an entity that has an existing legal obligation to clean up contamination in a country in which the government is considering amending the law and requiring a higher standard of clean-up, should treat the change in the law as changing the nature of the underlying obligation. Therefore, it gives rise to a new obligation rather than changing the amount required to settle the existing obligation.

Reimbursements

BC89 IAS 37 specifies that if some or all of the expenditure required to settle a provision is to be reimbursed by another party, the reimbursement is not recognised unless it is 'virtually certain' that the reimbursement will be received.

BC90 The Board observed that most reimbursements arise from insurance contracts, indemnity clauses or suppliers' warranties. Therefore, the Board observed that in such examples an entity has a conditional right and an unconditional right that satisfies the definition of an asset. That is to say, the reimbursement itself is a conditional right, but the insurance contract, indemnity clause or supplier's warranty establishes an unconditional right for the entity that satisfies the definition of an asset. Consistently with its conclusions relating to contingent assets, the Board decided that it should amend the requirements relating to reimbursements to explain that the reimbursement asset an entity should recognise is the *right* to reimbursement, and not the reimbursement, because this is the unconditional right that the entity controls.

BC91 The Board concluded that the right to reimbursement should be recognised following the recognition criteria in the *Framework*, ie if it is probable that any future economic benefits associated with the asset will flow to the entity and the item has a value that can be measured reliably. The Board

noted that the probability recognition criterion should be applied to the asset (ie unconditional right) and not the reimbursement (ie conditional right). This means that if an entity has a *right* to reimbursement, the probability recognition criterion would always be satisfied because the economic benefits embodied in the unconditional right are a certainty—there is no uncertainty that the entity has a right to look to another entity for reimbursement. The uncertainty relates to the amount of economic benefits that will flow from the conditional right. Because of this, and to ensure that entities do not incorrectly apply the probability recognition criterion to the conditional right, the Board concluded that it should specify as a recognition criterion only reliable measurement. The Board's view is that if the entity has recognised a non-financial liability and has an unconditional right to reimbursement, that right to reimbursement warrants recognition as an asset.

Transition

BC92 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires a change in accounting policy upon initial application of a Standard to be applied retrospectively (ie to all periods presented). However, the Board noted that unless it set the effective date two or three years after issuing the revised IAS 37, an existing user of IFRSs would, in many instances, find it impracticable to apply the amendments retrospectively. This is because the Board believes that the most significant effect of the proposals in the Exposure Draft is to require entities to recognise, as non-financial liabilities, items that were not previously recognised (and, in some cases, not considered to be liabilities). Thus, until the proposals are confirmed in a final Standard, entities would have had no reason to collect the necessary information to measure these items. Hence, requiring entities to recognise and measure such items as at dates before the final Standard is issued would, in many cases, require the inappropriate use of hindsight.

BC93 When it is impracticable to apply a new accounting policy retrospectively, paragraph 24 of IAS 8 requires an entity to apply the new policy to the carrying amount of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period. The Board concluded that the earliest period for which it would be practicable to apply the revised IAS 37 would be periods beginning on or after the date the revised Standard is issued (expected to

be in 2006). Because of this, and because the Board proposes the same effective date for the revised IAS 37 as for the revised IFRS 3 which it accompanies (ie 1 January 2007), the Board proposes to prohibit entities from applying the revised IAS 37 for accounting periods beginning before the date it is issued and from restating comparative information.

BC94 The Board noted that a similar question about impracticability would arise for any first-time adopter of IFRSs with a date of transition to IFRSs before the date the revised IAS 37 is issued. This is because, in the absence of any specific exemption in IFRS 1 *First-time Adoption of International Financial Reporting Standards*, a first-time adopter applies the IFRSs effective at its reporting date for its first IFRS financial statements. So, for example, a first-time adopter that has a first IFRS reporting period ending on 31 December 2007 and includes comparative information for two years would be required to apply the amended IAS 37 from 1 January 2005. Therefore, the Board decided to propose a new exemption in IFRS 1 that specifies the same transitional requirements for a first-time adopter of IAS 37 as for an existing user of IFRSs.

Alternative view on Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

AV1 One Board member voted against the publication of the Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The Board member's alternative view is set out below.

Alternative view of the Board member

AV2 The Board member voted against the publication of the proposals for the following reason. The Board member objects to the omission of the probability recognition criterion (paragraph 14(b) of IAS 37) from proposed paragraph 11.

AV3 The Board member acknowledges that the new analysis of items previously described as contingent liabilities, requiring unconditional obligations as a condition for recognition, is more elegant than the previous IAS 37 requirement based on the probability of cash flows, which failed to distinguish element uncertainty[5] from measurement uncertainty.

AV4 However, the Board member believes that the new analysis fails to provide adequate guidance on when an unconditional obligation should be recognised, and, in particular, what level of element uncertainty would preclude recognition. The Exposure Draft accepts that such an obligation may be constructive, rather than supported by a legal contract, and that the identification of a constructive obligation will necessarily require judgement, based on probabilities, a concept previously covered by paragraph 14(b) (cf 'reasonably expect' in proposed paragraph 15). The point at which such an obligation arises (and recognition is triggered) will be determined by an obligating event.

AV5 In the absence of a clear definition of the conditions for recognising when an unconditional obligation exists, the Board member believes that the implications of the new approach are unclear. For example, in paragraph BC29 it is asserted that 'until the new law is substantively enacted, the entity would have no present unconditional obligation (unless the entity by its own actions created a constructive obligation before the law was enacted) … and, therefore, no liability'. In these circumstances, it is not clear why the entity's previous actions that made it vulnerable to the consequences of a possible law change (which the entity has little, if any, discretion to avoid) did not necessarily create an unconditional obligation to bear the consequences of a change in the law and a liability.

AV6 On the other hand, in paragraph BC46 it is asserted that the initiation of a lawsuit will create an unconditional obligation and a liability (if not already recognised). It seems difficult to justify this distinction between a prospective change in statute law (which may be highly probable) and the judgement of a court (which may be highly unlikely to lead to an obligation to pay, if the suit is vexatious or trivial), especially in those countries that have a common law system in which the courts determine the law.

[5] The *Statement of Principles for Financial Reporting* of the Accounting Standards Board in the United Kingdom explains that element uncertainty arises 'in the case of a potential liability [when] there could be uncertainty whether the obligation exists and whether that obligation might require the reporting entity to transfer economic benefits' (paragraph 5.13).

IASB Exposure Draft June 2005

AV7 The Board member therefore concludes that the probability recognition criterion in paragraph 14(b) should continue to apply to the recognition of an unconditional obligation.

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Illustrative Examples

These examples accompany, but are not part of, [draft] IAS 37.

Contents

All the entities in the examples have 31 December year-ends. In all cases, it is assumed that the non-financial liability can be measured reliably. In some examples, the circumstances described may have resulted in impairment of assets—this aspect is not dealt with in the examples.

Example 1: Disputed lawsuit

After a wedding in 20X0, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings have been started seeking damages from the entity. However, the entity disputes liability because it does not believe that its food was harmful. Up to the date of authorisation for issue of the financial statements for the year to 31 December 20X0, the entity's lawyers advise that it is unlikely that the entity will be found liable.

Present obligation as a result of a past event – The past event is the start of legal proceedings. Up to this point, the entity was not aware that it had sold harmful food. Even at the time the entity authorises for issue its financial statements, it disputes that it sold harmful food. Nonetheless, the start of legal proceedings obliges the entity to stand ready to perform as the court directs and hence the entity has a present obligation.

Conclusion – A non-financial liability is recognised.

A note about measurement – The objective in measuring the liability is to estimate the amount that the entity would rationally pay to settle or to transfer the obligation *on* the balance sheet date. Even if the entity expects that it will not be found liable, no other party would assume the obligation on the balance sheet date without being compensated by the entity. This is because of the costs involved in defending the lawsuit and the risk of an adverse outcome.

In measuring the liability at 31 December 20X0, the entity considers factors such as:

- the possible outcomes of the lawsuit;
- the cash flows associated with those outcomes (including the costs associated with the lawsuit);
- the timing of the cash flows;

- the probabilities of those outcomes; and
- the risks and uncertainties associated with the obligation (ie the range or variability of the possible outcomes).

The last factor is sometimes referred to as a 'risk adjustment' and it is the amount that a third party would demand for bearing the uncertainty and unforeseeable circumstances inherent in the obligation concerning the amount and timing of any cash flows.

Example 17 gives guidance on the use of an expected cash flow approach, in which multiple cash flow scenarios are weighted by their respective probabilities, as the basis for measuring a liability.

Example 2: Potential lawsuit

Shortly before 31 December 20X0, a patient dies in a hospital as a result of a mistake made during an operation. The hospital is aware that a mistake occurred. In these circumstances, the hospital's past experience and lawyers' advice indicate that it is highly likely that the patient's relatives will start legal proceedings and, if the matter comes to court, that the hospital will be found guilty of negligence.

At the time that the financial statements are authorised for issue in early 20X1, the hospital has not received notice of legal proceedings against it.

Present obligation as a result of a past event – The past event is the operation in which negligence occurred.

Conclusion – A non-financial liability is recognised.

A note about measurement – Measurement of the liability reflects the likelihood that the hospital will be required to pay compensation because of the mistake, and the amount and timing of that compensation.

Example 3A: Contaminated land – legislation substantively enacted

An entity in the oil industry causes contamination, but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates previously had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. The government, however, is considering introducing new legislation that will require contamination, including prior contamination, to be cleaned up. By 31 December 20X0, the new law is substantively enacted.

Present obligation as a result of a past event – The past event is the substantive enactment of legislation requiring the contaminated land to be cleaned up. Therefore, the entity has a present obligation to clean up its contamination.

Conclusion – A non-financial liability is recognised for the clean-up obligation.

A note about measurement – Measurement of the liability on 31 December 20X0 reflects uncertainty about the timing and amount of the expenditure required to clean up the contamination.

Example 3B: Contaminated land and constructive obligation

An entity in the oil industry causes contamination and operates in a country in which there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy.

Present obligation as a result of a past event – The past event is the contamination of the land, which gives rise to a present constructive obligation. This is because:

- by publishing its environmental policy the entity has publicly indicated that it will accept the responsibility to clean up its contamination.
- by publishing that policy and honouring it in the past, other parties can reasonably rely on the entity to clean up its contamination.

- other parties will suffer harm if the entity does not clean up its contamination.

Conclusion – A non-financial liability is recognised for the clean-up obligation.

Example 4A: Extended product warranty

A manufacturer sells extended product warranties to purchasers of its product. Under the terms of the warranty contract the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale.

Present obligation as a result of a past event – The past event is the sale of the warranty, which gives rise to a present obligation to provide a service for the duration of the warranty (ie to stand ready to honour warranty claims).

Conclusion – A non-financial liability is recognised.

A note about measurement

– In the absence of market evidence to determine the amount needed to settle or transfer the warranty obligation on the balance sheet date, the entity considers factors such as:

- the estimated number of claims that will arise from warranties sold on or before the balance sheet date. In estimating the number of claims, the entity may develop a number of different scenarios of possible claims, weighting each by its respective probability.
- the cash flows associated with meeting the estimated number of claims.
- the timing of the cash flows.
- the risks and uncertainties associated with the obligation (ie the range or variability of the possible outcomes).

When an entity issues product warranties in exchange for a fee, revenue is recognised in accordance with IAS 18 *Revenue*.

Example 4B: Extended product warranty – no constructive obligation

The facts are the same as Example 4A. However, in addition, in this example the entity frequently repairs or replaces the product if manufacturing defects become apparent in the fourth and fifth year after the date of sale in order to maintain customer goodwill. The entity does not make this practice widely known. In addition, the entity carefully scrutinises any claims it receives in the fourth and fifth year following the date of sale to assess the costs of repairing or replacing the product against the potential damage to customer goodwill.

Present obligation as a result of a past event – There is no constructive obligation at the date of sale to provide warranty coverage in the fourth and fifth years following the date of sale. Although the entity frequently repairs products after the contractual warranty period has expired, the entity has not indicated to its customers that this is its general practice. In addition the entity retains discretion about whether it will meet claims after expiry of the warranty period, and hence customers cannot reasonably rely on the entity to meet such claims.

Conclusion – No liability is recognised for warranty coverage after expiry of the warranty period.

Example 5: Single guarantee

On 31 December 20X0 Entity A gives a guarantee of specified borrowings of Entity B, whose financial condition at that time is sound. During 20X1 the financial condition of Entity B deteriorates and at 30 June 20X1 Entity B files for protection from its creditors.

This contract meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*. IFRS 4 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. IFRS 4 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that IFRS 4 permits.

Present obligation as a result of a past event – The past event is issuing the guarantee. This gives rise to a present obligation to provide a service for the duration of the guarantee (ie to stand ready to repay the borrowing of Entity B).

Conclusion – A liability is recognised.

A note about measurement – The guarantee is initially recognised at fair value. Subsequently, it is measured at the higher of (a) the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party, and (b) the amount initially recognised in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.

Example 6: Offshore oilfield

An entity operates an offshore oilfield. Its licensing agreement for the oilfield requires the entity to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10 per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed, but no oil has been extracted.

Present obligation as a result of a past event – The construction of the oil rig creates a present obligation under the terms of the licence to remove the rig and restore the seabed. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

Conclusion – A non-financial liability is recognised for the entity's obligation to remove the oil rig and restore the damage caused by building it.

A note about measurement – The measurement of the liability at the balance sheet date reflects that only 90 per cent of the eventual costs of removing the oil rig and restoring the seabed are attributable to building the oil rig. The obligation to restore the damage that arises through the extraction of oil is recognised as it is incurred, ie when the oil is extracted.

The amount of the liability recognised initially is included in the cost of the oil rig in accordance with IAS 16 *Property, Plant and Equipment*. Subsequent changes in

the measurement of the liability are recognised in accordance with IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

Example 7: Contingent asbestos removal obligation

An entity acquires a factory that contains asbestos. After the acquisition date, new laws come into effect that require the entity to handle and dispose of the asbestos in a special way if the factory undergoes major renovation or is demolished. Otherwise, the entity is not required to remove the asbestos from the factory. The entity has several options to retire the factory in the future including demolishing, selling, or abandoning it.

Present obligation as a result of a past event – Although performance of the removal of the asbestos is conditional on the major renovation or demolition of the factory, enactment of the law creates a present obligation for the entity to remove and dispose of asbestos in a special way. Although the entity may decide to abandon the factory, and thereby defer settlement of the obligation for the foreseeable future, the ability to abandon the factory, and thereby defer settlement, does not relieve the entity of the obligation. The asbestos will eventually need to be removed and disposed of in a special way. In addition, the ability of the entity to sell the factory before disposal of the asbestos does not relieve the entity of its obligation. The sale of the asset would transfer the obligation to another entity and that transfer would affect the selling price.

Conclusion – A non-financial liability for the obligation to remove the asbestos is recognised when the law is enacted.

Example 8: Joint and several liability

In 20X0, Entity A and Entity B enter into a joint arrangement to extract minerals from land owned by Entity C. As part of the agreement with Entity C, Entity A and Entity B are jointly and severally liable for the obligation to restore Entity C's land at the completion of extraction (expected to be in 20X9). The agreement between Entity A and Entity B specifies that Entity B will restore the land. During 20X5, the financial condition of Entity B deteriorates, raising the possibility that Entity A will be required to restore the land in 20X9.

Present obligation as a result of a past event – The agreement between Entity A and Entity C gives rise to a present obligation for Entity A (ie to stand ready to restore the land). Although Entity B is primarily responsible for restoring the land, Entity C has a right to require Entity A to restore the land because of the joint and several nature of the agreement.

Conclusion – Entity A recognises a non-financial liability.

A note about measurement – In measuring its liability, Entity A reflects the likelihood that it, rather than Entity B, will be required to restore the land. Therefore, the liability may not initially warrant recognition on the basis of materiality. When Entity A recognises a liability, it also considers recognising an asset for its right to reimbursement from Entity B as a result of the agreement specifying that Entity B is responsible for restoring the land.

Example 9: Refunds policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past event – The past event is the sale of the product, which gives rise to a present constructive obligation to stand ready to make refunds to dissatisfied customers. This is because:

- by making its policy of refunding purchases generally known, the entity has publicly indicated that it will refund customers.
- by making its policy generally known, customers can reasonably rely on the entity to refund their purchases.
- customers will suffer harm if the entity does not refund their purchases in accordance with its policy.

Conclusion – A non-financial liability is recognised for the entity's obligation to stand ready to provide refunds.

A note about measurement – Measurement of the liability reflects the likelihood of the entity being required to refund purchases made by customers before the balance sheet date and the timing and amount of those refunds.

Any revenue received from the transaction to which the refund obligation relates is accounted for in accordance with IAS 18.

Example 10A: New legislation 1

An entity sells electrical products in a country whose government is considering introducing new environmental legislation. If enacted, the legislation would require the entity to take back its products from customers for recycling and disposal. The legislation is expected to be retrospective. Hence, customers are expected to be able to return products for disposal that were sold before enactment of the legislation now being considered.

At the balance sheet date, the legislation has not been substantively enacted.

Present obligation as a result of a past event – At the balance sheet date there is no present obligation (unless the entity by its own actions created a constructive obligation before the law was substantively enacted). Until the law is substantively enacted, the entity does not have a present obligation with respect to that law.

Conclusion – No liability is recognised.

Example 10B: New legislation 2

The facts are the same as in example 10A. However, in this example the entity had previously entered into a contract with a counterparty. In accordance with the terms of the contract, the entity is indemnified by the counterparty against the costs of recycling and disposing of its electrical products sold before the date on which it entered into the contract.

Present obligation as a result of a past event – At the balance sheet date, the counterparty has a present obligation as a result of entering into the contract.

Conclusion – The counterparty recognises a liability.

This is an example of an insurance contract, which is outside the scope of IAS 37. However, it is included for illustrative purposes.

Example 11: Closure of a division

On 12 December 20X0 the management of an entity approved a detailed plan for closing a division. The plan requires termination of (a) various contracts and (b) the employment of the division's employees. On 31 December 20X0 the entity issued a press release announcing its decision to close the division.

Before the entity took the decision to close the division, none of the contracts was regarded as onerous.

On 31 January 20X1 the entity gave notice, under the terms of its contracts, to the relevant counterparties to terminate its contracts and on 1 March 20X1 the entity began to terminate the employment of its employees.

(a) At the balance sheet date of 31 December 20X0

Present obligation as a result of a past event – There has been no past event giving rise to a present obligation to restructure. The public announcement of the entity's intention to close the division does not, by itself, create a present obligation.

Conclusion – No liability is recognised.

(b) At 31 January 20X1

Present obligation as a result of a past event – The event that makes the contracts onerous is giving notice to terminate them.

Conclusion – A liability is recognised at 31 January 20X1 for any contract termination costs.

The entity recognises termination benefits in accordance with the requirements of IAS 19 *Employee Benefits*.

Example 12: Onerous contract

An entity operates profitably from a factory it leases under an operating lease. During December 20X0 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years and it cannot be cancelled. Since the lease started, lease rates on commercial buildings in the entity's location have declined.

Present obligation as a result of a past event – The lease contract for the old factory gave rise to a legal obligation. The contract is now onerous because the entity does not expect to receive economic benefits from the factory and the contract gives rise to unavoidable costs (ie the remaining lease rentals reduced by the estimated sublease rentals that could reasonably be obtained for the factory). The past event that makes this lease contract onerous is the entity vacating the old factory.

Conclusion – A liability is recognised.

A note about measurement – Measurement of the liability is by reference to the unavoidable lease payments reduced by the estimated sublease rentals that the entity could reasonably obtain, even if the entity does not intend to enter into a sublease.

Example 13: Legal requirement to install smoke filters

Under new legislation, an entity is required to install smoke filters in its factories by 30 June 20X1, otherwise it will incur penalties. At 31 December 20X1 the entity has not installed the smoke filters but has continued to operate the factories.

(a) At the balance sheet date of 31 December 20X0

Present obligation as a result of a past event – There is no present obligation because there is no past event either for the costs of installing smoke filters or for penalties under the legislation. This is because (a) the entity has the discretion to avoid installing the smoke filters and (b) at 31 December 20X0 the entity is in compliance with the legislation.

Conclusion – No liability is recognised for the cost of installing the smoke filters.

(b) At the balance sheet date of 31 December 20X1

Present obligation as a result of a past event – There is no obligation for the costs of installing smoke filters because a past event committing the entity to install the filters has not occurred. The entity can stop using the factory and therefore avoid installing the filters. However, the failure to comply with legislation is a past event giving rise to a present obligation, because the entity will be obliged to pay the penalties imposed under the legislation for non-compliant operation of the factory.

Conclusion – No liability is recognised for the costs of installing smoke filters. However, a non-financial liability is recognised for the obligation to pay fines and penalties.

Example 14: Staff retraining as a result of changes in the income tax system

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

Present obligation as a result of a past event – There is no obligation because no past event (ie retraining) has taken place. This is because the entity has the discretion to avoid retraining its workforce.

Conclusion – No liability is recognised.

Example 15: Repairs and maintenance

Some items of property, plant and equipment require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major parts. IAS 16 gives guidance on

allocating the amount recognised in respect of an item of property, plant and equipment to its significant parts.

Example 15A: Refurbishment costs – no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past event – There is no present obligation.

The cost of replacing the lining is not recognised as a liability because, at the balance sheet date, no obligation to replace the lining exists independently of the entity's future actions—even the intention to incur the expenditure depends on the entity deciding to continue operating the furnace or to replace the lining. Instead of a liability being recognised, the depreciation of the lining takes account of its consumption, ie it is depreciated over five years. The costs of replacing the lining then incurred are recognised as a part of the carrying amount of the furnace with the consumption of each new lining shown by depreciation over the subsequent five years.

Conclusion – No liability is recognised.

Example 15B: Refurbishment costs – legislative requirement

An airline is required by law to overhaul its aircraft once every three years as a condition of continuing to operate them.

Present obligation as a result of a past event – There is no present obligation.

The costs of overhauling aircraft are not recognised as a liabiity for the same reasons the cost of replacing the lining is not recognised as a liability in example 15A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions. Instead of a liability being recognised, the depreciation of

the aircraft takes account of the future incidence of maintenance costs, ie an amount equivalent to the expected maintenance costs is depreciated over three years.

Conclusion – No liability is recognised.

Example 16: Self-insurance

An entity that operates a chain of retail outlets reviews its insurance arrangements for its liability in respect of accidents sustained by customers. The entity is not required to have public liability insurance coverage and decides to 'self insure', ie to retain the risk of claims from customers.

Present obligation as a result of a past event – There is no present obligation with respect to uninsured accidents that may arise in the future.

Conclusion – No liability is recognised for uninsured accidents that may arise in the future. A liability is recognised only for accidents that have occurred before the balance sheet date. The entity may have to make an estimate of accidents that have occurred but have not yet been reported to it.

Example 17: Measurement of a decommissioning obligation

The purpose of the example is to illustrate one way in which the requirements in paragraphs 29-42 may be applied.

An entity places an offshore oil rig into service. The entity is required by law to dismantle and remove the rig at the end of its useful life, which is estimated to be 10 years.

The entity estimates a range of cash flows (that include the effects of inflation) needed to dismantle and remove the rig, and assigns probability assessments to the range as follows.

Estimated cash flows and associated probabilities

Cash flow estimate	Probability assessment	Expected cash flows
CU	%	CU
200,000	25	50,000
225,000	50	112,500
275,000	25	68,750
Expected cash flow		231,250

The entity estimates that the cash flows should be increased by 5 per cent to reflect the uncertainties and unforeseeable circumstances inherent in the obligation (for example, the risk that removal of the rig may cost more than expected). This risk adjustment may be determined by considering factors such as the range of variability of the possible outcomes and the amount that a third party would typically demand for bearing the uncertainty and unforeseeable circumstances inherent in 'locking in' today's price for cash flows that are expected to occur in 10 years.

The entity estimates that the discount rate that reflects current market assessments of the time value of money is 6 per cent (risks specific to the liability are included by adjusting the above cash flow estimate).

The entity estimates the initial measurement of the obligation as follows:

	CU	CU
Expected cash flows	231,250	
Risk adjustment	11,563	
		242,813
Present value using rate of 6 per cent for 10 years		135,586

Example 18: Disclosure of a warranty obligation

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a liability of CU60,000 has been recognised. The following information is disclosed:

A liability of CU60,000 has been recognised for expected warranty claims on products sold during the last three years. It is expected that the majority of claims will occur in the next year, and all will occur within two years of the balance sheet date.

Example 19: Disclosure of a decommissioning obligation

In 2000 an entity involved in nuclear power generation recognises a liability for decommissioning costs of CU300 million. The liability is based on the decommissioning costs that are expected to be incurred, adjusted for risk, using existing technology. The costs reflect current prices and are discounted using a real discount rate of 2 per cent. The other significant assumption is that there is a 90 per cent likelihood that the decommissioning will take place in 60-70 years and a 10 per cent likelihood that it will not take place until 100-110 years. The following information is disclosed:

A liability of CU300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2060 and 2070. However, there is a possibility that decommissioning will not take place until 2100-2110. The likelihood of these different outcomes is reflected in the measurement of the liability. The liability has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2 per cent.

Example 20: Disclosure exemption

An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of CU100 million. The entity recognises a non-financial liability for the amount that it would rationally pay to

settle or transfer the obligation, but discloses none of the information required by paragraph 68 of the [draft] Standard because this information can be expected to prejudice seriously its position. The following information is disclosed:

The company is in a dispute with a competitor. This has resulted in litigation against the company alleging that it has infringed patents and seeking damages of CU100 million. The information usually required by [draft] IAS 37 Non-financial Liabilities *is not disclosed because it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.*

IASB Exposure Draft June 2005

Table of Concordance

This table shows how the contents of IAS 37 and the Exposure Draft correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

IAS 37 paragraph	Exposure Draft paragraph
Objective	1
1	2
2	None
3	3
4	None
5	4
6	7
7	None
8	8
9	None
10	10
11	None
12	None
13	None
14	11
15	None
16	None
17	13
18	None
19	17, 18
20	19
21	20
22	21
23	None

IAS 37 paragraph	Exposure Draft paragraph
24	None
25	27
26	28
27-30	22-26
31-35	IAS 38 17A & 17B
36	29
37	None
38	32
39	31
40	31
41	34
42	35
43	36
44	37
45	38
46	39
47	38
48	41
49	42
50	42
51	None
52	None
53	46
54	50

IAS 37 paragraph	Exposure Draft paragraph
55	47
56	49
57	49
58	None
59	43
60	45
61	None
62	None
63	52
64	53
65	54
66	55
67	56
68	58
69	59
70	60
71	61
72	None
73	None
74	None
75	66
76	None
77	None
78	None

IAS 37 paragraph	Exposure Draft paragraph
79	None
80	None
81	65
82	None
83	None
84	67, 68
85	68
86	69
87	70
88	None

IAS 37 paragraph	Exposure Draft paragraph
89	None
90	None
91	None
92	71
93	72
95	72
Example 1	4A
Example 2	3
Example 3	6
Example 4	9

IAS 37 paragraph	Exposure Draft paragraph
Example 5	11
Example 6	13
Example 7	14
Example 8	12
Example 9	5
Example 10	1
Example 11	15
Disclosure Example 1	18
Disclosure Example 2	19
Disclosure Example 3	20

PROPOSED AMENDMENTS TO

IAS 19
EMPLOYEE BENEFITS

ED 140

INVITATION TO COMMENT

The Board would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale, and, when applicable, provide a suggestion for alternative wording.

Question 1 – Definition of termination benefits

The Exposure Draft proposes amending the definition of termination benefits to clarify that benefits that are offered in exchange for an employee's decision to accept voluntary termination of employment are termination benefits only if they are offered for a short period (see paragraph 7). Other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits (see paragraph 135).

Do you agree with this amendment? If not, how would you characterise such benefits, and why?

Question 2 – Recognition of termination benefits

The Exposure Draft proposes that voluntary termination benefits should be recognised when employees accept the entity's offer of those benefits (see paragraph 137). It also proposes that involuntary termination benefits, with the exception of those provided in exchange for employees' future services, should be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria (see paragraph 138).

Is recognition of a liability for voluntary and involuntary termination benefits at these points appropriate? If not, when should they be recognised and why?

Question 3 – Recognition of involuntary termination benefits that relate to future service

The Exposure Draft proposes that if involuntary termination benefits are provided in exchange for employees' future services, the liability for those benefits should be

recognised over the period of the future service (see paragraph 139). The Exposure Draft proposes three criteria for determining whether involuntary termination benefits are provided in exchange for future services (see paragraph 140).

Do you agree with the criteria for determining whether involuntary termination benefits are provided in exchange for future services? If not, why not and what criteria would you propose? In these cases, is recognition of a liability over the future service period appropriate? If not, when should it be recognised and why?

SUMMARY OF MAIN CHANGES (IAS 19)

The following main changes are proposed:

Definition of termination benefits

- The definition of termination benefits in IAS 19 includes employee benefits that are payable as a result of an employee's decision to accept voluntary redundancy in exchange for those benefits. The Exposure Draft proposes that:
  - the definition should be amended to clarify that benefits that are payable in exchange for an employee's decision to accept voluntary redundancy are termination benefits only if they are offered for a short period.
  - other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits.

Recognition

- IAS 19 states that termination benefits should be recognised when the entity is demonstrably committed either to terminating the employment of employees before the normal retirement date or to providing termination benefits as a result of an offer made in order to encourage voluntary redundancy. The Exposure Draft proposes that:
  - voluntary termination benefits should be recognised when employees accept the entity's offer of those benefits.
  - involuntary termination benefits should be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria, unless the involuntary termination benefits are provided in exchange for employees' future services (ie in substance they are a 'stay bonus'). In such cases, the liability for those benefits should be recognised over the future service period.

Contents

PROPOSED AMENDMENTS TO INTERNATIONAL ACCOUNTING STANDARD 19

EMPLOYEE BENEFITS

For ease of reference, paragraphs proposed to be amended are shown with new text underlined and deleted text struck through. Proposed new paragraphs are not underlined.

Definitions

Paragraph 7 is amended as follows.

7 The following terms are used in this Standard with the meanings specified:

...

Termination benefits **are employee benefits ~~payable as a result of~~ provided in connection with the termination of an employee's employment. They may be either:**

(a) involuntary termination benefits, which are benefits provided as a result of an entity's decision to terminate an employee's employment before the normal retirement date; or

(b) voluntary termination benefits, which are benefits offered for a short period in exchange for an employee's decision to accept voluntary ~~redundancy~~ termination of employment ~~in exchange for those benefits~~.

The *minimum retention period* is the period of notice that an entity is required to provide to employees in advance of terminating their employment. The notice period may be specified by law, contract or union agreement, or may be implied as a result of customary business practice.

...

Termination benefits

Paragraph 132 is amended; paragraph 135 is moved, amended and renumbered as 133; paragraphs 134 and 135 are added; and paragraph 136 is moved and amended as follows.

132 This Standard deals with termination benefits separately from other employee benefits because, except as described in paragraphs 139 and 140, the event ~~which~~ that gives rise to an obligation is the termination of employment rather than employee service.

~~135~~133 ~~An entity may be committed, by legislation, by contractual or other agreements with employees or their representatives or by a constructive obligation based on business practice, custom or a desire to act equitably, to make payments (or provide other benefits) to employees when it terminates their employment. Such payments are termination benefits.~~ Termination benefits are typically lump-sum payments, but sometimes also include:

(a) enhancement of retirement benefits or of other post-employment benefits, either indirectly through an employee benefit plan or directly; and

(b) salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity.

134 Involuntary termination benefits are often provided in accordance with the terms of an ongoing benefit plan. For example, they may be specified by statute, employment contract or union agreement, or may be implied as a result of the employer's past practice of providing similar benefits. In other cases, they are provided at the discretion of the entity and are incremental to what an employee would otherwise be entitled to, for example because the entity has no ongoing benefit plan or provides benefits in addition to those specified by an ongoing benefit plan.

135 Some entities offer benefits to encourage employees to accept voluntary termination of employment before normal retirement date. For the purpose of this [draft] Standard, such benefits are termination benefits only if they are offered for a short period. Other benefits offered to encourage employees to accept voluntary termination of employment (for example, those available under the terms of an ongoing benefit plan) are post-employment benefits because the benefits are payable in exchange for the employees' service.

136 Some employee benefits are ~~payable~~ provided regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits are described in some ~~countries~~ jurisdictions as termination indemnities, or termination gratuities, they are post-employment benefits~~, rather than termination benefits and an entity accounts for them as post-employment benefits~~. Some entities provide a lower level of benefit for voluntary termination of employment at the request of the employee (in substance, a post-employment benefit) than for involuntary termination at the request of the entity. The additional benefit payable on involuntary termination of employment is a termination benefit.

Recognition

Paragraphs 133, 134, 137 and 138 are deleted and paragraphs 137-142 are added as follows.

137 An entity shall recognise a liability and expense for voluntary termination benefits when the employee accepts the entity's offer of those termination benefits.

138 Except as specified in paragraph 139, an entity shall recognise a liability and expense for involuntary termination benefits when it has a plan of termination that it has communicated to the affected employees, and actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The plan shall:

(a) identify the number of employees whose employment is to be terminated, their job classifications or functions and their locations, and the expected completion date; and

(b) establish the benefits that employees will receive upon termination of employment (including but not limited to cash payments) in sufficient detail to enable employees to determine the type and amount of benefits they will receive when their employment is terminated.

139 If involuntary termination benefits are provided in exchange for employees' future services, an entity shall recognise the termination benefits as a liability and an expense over the period of the employees' future services (ie from the date specified in paragraph 138 to the date that employment is terminated).

140 In some cases, involuntary termination benefits are provided in exchange for employees' future services. For the purpose of this [draft] Standard, this is the case if those benefits:

(a) are incremental to what the employees would otherwise be entitled to receive (ie the benefits are not provided in accordance with the terms of an ongoing benefit plan);

(b) do not vest until the employment is terminated; and

(c) are provided to employees who will be retained beyond the minimum retention period.

141 In some cases, employers provide involuntary termination benefits that are expressed as an enhancement of the existing terms of an ongoing benefit plan. Examples are a doubling of benefits specified by employment legislation and an increase in retirement benefits to be provided through a post-employment benefit plan. If the termination benefits that are attributable to the enhancement of the ongoing benefit plan do not represent a change to the terms of the ongoing plan (and therefore would not apply to employees leaving service in the future) and satisfy the criteria in paragraph 140(b) and (c), they shall be recognised in accordance with paragraph 139.

142 When termination benefits are provided through a post-employment benefit plan, the liability and expense recognised initially include only the value of the additional benefits that arise from providing those termination benefits. Other changes in any defined benefit obligation for the post-employment benefit plan resulting from employees leaving employment at a date earlier than originally assumed should be recognised either as actuarial gains or losses or as a curtailment.

Measurement

Paragraphs 139 and 140 are amended and renumbered as 143 and 145, and paragraph 144 and the illustrative example are added as follows.

~~139~~143 ~~Where~~ When termination benefits ~~fall~~ are due more than 12 months after the balance sheet date, ~~they~~ an entity shall ~~be~~ discount~~ed~~ them using the discount rate specified in paragraph 78 and shall subsequently follow the recognition and measurement requirements for post-employment benefits.

144 Accordingly, when termination benefits are provided through a post-employment benefit plan, their initial measurement and subsequent recognition and measurement are consistent with the requirements of IAS 19 for the underlying post-employment benefit plan.

~~140~~145 ~~In the case of an offer made to encourage voluntary redundancy, the M~~measurement of a liability for unvested involuntary termination benefits shall ~~be based on the number of employees expected to accept the offer~~ reflect the likelihood of employees leaving voluntarily before the termination benefits vest.

Example illustrating paragraphs 138-145

Background

As a result of a recent acquisition, an entity plans to close a factory in 12 months and, at that time, terminate the employment of all of the remaining employees at the facility. Because the entity needs the expertise of the employees at the facility to complete some contracts, it announces a termination benefit plan as follows. Each employee who stays and renders service for the full 12-month period will receive as a termination benefit on the termination date a cash payment of three times the amount specified by employment legislation.

The entity's usual practice is to pay only the minimum termination benefits specified by employment legislation. For the employees at the factory, this minimum amounts to 10,000 per employee. Employment legislation also requires the entity to give 60 days' notice of its intention to terminate employment.

There are 120 employees at the factory, 20 of whom are expected to leave voluntarily before closure. Therefore, the total expected cash flows under the termination benefit plan are 3,200,000 (ie 20 × 10,000 + 100 × 30,000).

As required by paragraph 141, the entity accounts for the benefits provided in accordance with the ongoing benefit plan (ie employment legislation) and the enhancement separately.

Ongoing benefit plan

A liability of 1,200,000 (ie 120 × 10,000) for the termination benefits provided in accordance with the ongoing benefit plan is recognised when the plan of termination is announced. The liability represents the benefits of 1,200,000 that the entity is required to pay in accordance with legislation.

Incremental benefits

The expected cash flows for the termination benefits that are incremental to what the employees would otherwise be entitled to receive (and relate to future services) are 2 million (ie 100 × 20,000). In this example, discounting is not required, so a liability and expense of 166,667 (ie 2,000,000 ÷ 12) is recognised in each month during the future service period of 12 months. If the number of employees expected to leave voluntarily before closure changes, the entity makes corresponding adjustments to its estimate of the expected cash flows for termination benefits and hence the liability recognised.

Disclosure

Paragraph 141 is deleted and paragraphs 142 and 143 are amended and renumbered as 146 and 147 as follows.

~~142~~146 As required by IAS 1, an entity discloses the nature and amount of an expense if it is material. The expense for ~~T~~termination benefits may ~~result in an expense~~ need~~ing~~ to be ~~disclosure~~ disclosed ~~in order~~ to comply with ~~this~~ that requirement.

~~143~~147 ~~Where~~ When required by IAS 24, ~~*Related Party Disclosures*~~ an entity discloses information about termination benefits for key management personnel.

Effective Date

Paragraph 159D is added as follows.

159D An entity shall apply the amendments in [draft] paragraphs 7 and 132-147 from the beginning of its first annual period commencing on or after [1 January 2007]. Comparative information shall not be restated. Earlier application is encouraged. However, an entity shall apply the amendments only from the beginning of an annual period commencing on or after [date the amendments are issued]. If an entity applies the amendments before the effective date, it shall disclose that fact.

Other amendments to the Standard

As a consequence of the amendments above, other paragraphs are amended as described below.

Paragraph 111 is amended as follows.

111 A curtailment occurs when an entity either:

(a) ~~is demonstrably committed to~~ makes a material reduction in the number of employees covered by a plan; or

(b) amends the terms of a defined benefit plan ~~such~~ so that a material element of future service by current employees will no longer qualify for benefits, or will qualify only for reduced benefits.

A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. ~~An event is material enough to qualify as a curtailment if the recognition of a curtailment gain or loss would have a material effect on the financial statements.~~ Curtailments are often linked with ~~a restructuring~~ the provision of termination benefits. Therefore, an entity accounts for a curtailment at the same time as for ~~a~~ any related ~~restructuring~~ termination benefits.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the proposed Amendments to IAS 19.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft of Proposed Amendments to IAS 19 *Employee Benefits*. Individual Board members gave greater weight to some factors than to others.

BC2 The amendments to IAS 19 proposed in this Exposure Draft result from the Board's Short-term Convergence project and complement the proposed amendments to the requirements addressing restructurings in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for employee benefits established by IAS 19, this Basis for Conclusions does not discuss requirements in IAS 19 that the Board has not reconsidered.

Short-term Convergence project

BC4 In September 2002 the Board decided to add a Short-term Convergence project to its active agenda. The objective of the project is to reduce differences between IFRSs and US generally accepted accounting principles (US GAAP) that are capable of resolution in a relatively short time and can be addressed outside current and planned major projects. The project is a joint project with the Financial Accounting Standards Board (FASB) in the United States.

BC5 In working towards the objective of the project, the two boards agreed to review each other's deliberations on each of the selected possible convergence topics and choose the higher quality solution as the basis for convergence. For topics recently considered by either board, there is an expectation that whichever board had more recently deliberated that topic would have the higher quality solution.

BC6 As part of the review of topics recently considered by the FASB, the Board considered the requirements of FASB Statement No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146), which was issued in June 2002. This has resulted in the Board proposing amendments to the requirements in IAS 37 relating to the recognition of liabilities for costs associated with a restructuring to converge with SFAS 146 and to improve the Standard. SFAS 146 also specifies the accounting for a class of termination benefits known as 'one-time termination benefits'. These are 'benefits provided to current employees that [sic] are involuntarily terminated under the terms of a benefit arrangement that, in substance, is not an ongoing benefit arrangement or an individual deferred compensation contract.' Because the accounting for termination benefits is specified by IAS 19, the Board also decided to amend the termination benefit recognition requirements in IAS 19 consistently with its amendments to IAS 37.

BC7 SFAS 146 does not alter the accounting for other termination benefits specified by earlier FASB Statements (principally Statement No. 88 *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (SFAS 88) and Statement No. 112 *Employers' Accounting for Postemployment Benefits*). Although the aim of the Short-term Convergence project is to reduce differences between IFRSs and US GAAP, the Board decided that in general it should not seek convergence with those earlier Statements. The Board observed that because the accounting for termination benefits in US GAAP is specified in a number of standards, the approach would be difficult to integrate into IAS 19. Accordingly, the Board concluded that it should converge with the principles of SFAS 146 relating to one-time termination benefits and apply those principles consistently to all termination benefits. It acknowledged that differences with US GAAP will remain following the introduction of these amendments. Nonetheless, the Board believes that the proposed amendments will increase convergence as well as improve the accounting for termination benefits.

Recognition of involuntary termination benefits payable in exchange for employees' future services

BC8 The present version of IAS 19 explains that termination benefits are dealt with separately from other employee benefits because the event that gives rise to a present obligation for termination benefits is the termination of employment rather than employee service. Therefore, a liability for termination benefits is recognised when the entity is 'demonstrably committed' to the termination. In contrast, SFAS 146 regards some one-time termination benefits as being provided in exchange for employees' future services (or, expressed another way, are in substance a 'stay bonus'). In such cases, the liability is recognised over the period of the employees' service, consistently with the accounting for other employee benefits.

BC9 The Board agreed with the FASB that in some cases termination benefits, although provided as compensation for the early termination of services, also have the characteristic of being provided in exchange for employees' future services. For example, the Board observed that, following an acquisition, entities sometimes terminate the employment of the employees of the acquired entity. However, because the entity requires the skills and knowledge of those employees for a period of time, it offers enhanced termination benefits as an inducement for those employees to stay for that period. Therefore, the Board decided that, like SFAS 146, IAS 19 should specify different recognition requirements for termination benefits that are provided in exchange for future service.

BC10 In SFAS 146, determining whether one-time termination benefits are provided in exchange for future service depends on whether employees are required to render future service to receive the benefits and, if so, whether they will be retained beyond the minimum retention period. This is because the FASB reasoned that, in the absence of a requirement to provide advance notice of termination, an entity would promise one-time termination benefits in advance of termination only if the entity needed the employees to render future service. In other words, if the employees are required to render future service to be entitled to the benefits, those benefits must be compensation for that future service. To accommodate any requirement to provide advance notice of termination, the FASB specified that if employees are required to render future service only during the minimum retention period to be entitled to the benefits, those benefits do not relate to future service.

BC11 Like the FASB, the Board concluded that it should specify when termination benefits are provided in exchange for future service, rather than leaving it to an assessment of the individual facts and circumstances. The Board was concerned that the latter approach could result in different entities accounting for similar termination benefits differently. The Board also agreed with the FASB's two criteria for determining whether one-time termination benefits are provided in exchange for future services. However, because the requirements in IAS 19 apply to all involuntary termination benefits, and not (as in SFAS 146) just one-time involuntary termination benefits, the Board decided that it needed to specify a third criterion, namely that the benefits are incremental to what the employees would otherwise be entitled to receive (or expressed another way, that the benefits are not provided in accordance with the terms of an ongoing benefit plan, whether that plan is established by an employment contract, union agreement, legal requirement, or implied by the entity's usual practice). The Board reasoned that if the termination benefits are paid in accordance with the terms of an ongoing benefit plan, those benefits would not be provided as an inducement to stay and render future service (and, hence, be provided in exchange for future services) because the entity would be obliged to provide them. In other words, the employees would know the benefits to which they would be entitled in the event of their employment being terminated. The Board noted that this would be counter to the notion in SFAS 146 of the employer making a payment completely at its discretion to encourage the employee to stay and render future service.

BC12 The Board noted that in some cases, termination benefits that are payable in exchange for future service would be calculated using a benefit formula that determines some (or all) of the termination benefits with reference to past service. However, the Board agreed with the FASB that the benefit formula 'in and of itself, does not render one-time termination benefits a 'reward' for past service. The [FASB] observed that an objective of providing a 'reward' for past service could be accomplished by granting immediately vested benefits.'[6] Accordingly, the Board concluded that such benefits should be recognised over the future service period, even though they are calculated by reference to past service.

BC13 The Board also noted that in some cases, an employer might offer termination benefits in excess of those specified by an ongoing benefit plan (for example, a doubling of benefits specified by employment legislation). The Board concluded that although the additional benefits might be expressed as an enhancement of the terms of the ongoing benefit plan, the additional benefits should be treated as a separate benefit plan. Thus, if the additional benefits are provided in exchange for employees' future services (because they do not represent an ongoing plan that would apply to future terminations and meet the criteria in paragraph 140(b) and (c)) they are recognised over future service periods.

BC14 The Board adopted the notion from SFAS 146 of a minimum retention period because, like the FASB, it acknowledged that a promise of termination benefits may need to be communicated to employees in advance of the termination as a result of law, contract or union agreement, rather than to induce the employees to continue in service until termination date. The Board, however, decided to broaden the definition to include notice periods that are implied by customary business practice.

Recognition of involuntary termination benefits

BC15 The Board then considered SFAS 146's recognition requirements for one-time termination benefits that are not payable in exchange for future services, ie one-time termination benefits that are paid to employees who are not required to render future service to receive the benefits or who will not be retained beyond the minimum retention period. In SFAS 146, the liability for such benefits is recognised when the entity has a plan of

[6] Paragraph B28 of SFAS 146.

termination that (a) meets specified criteria and (b) has been communicated to the employees in sufficient detail for them to be able to determine the termination benefits to which they are entitled.

BC16 The Board noted that the specific criteria in SFAS 146 relating to the termination plan are similar to the criteria in the present version of IAS 19 for establishing whether an entity is demonstrably committed to a termination plan and, therefore, should recognise termination benefits. However, the Board observed that there is no requirement in IAS 19 to communicate the plan of termination to employees. Having considered SFAS 146, the Board agreed with the FASB that there is no liability to provide one-time termination benefits until the entity has communicated the plan of termination to the employees. However, the Board decided that this principle in SFAS 146 should apply to all involuntary termination benefits and not just one-time termination benefits. The Board observed that even if the termination benefits are not one-time and, for example, are provided in accordance with the terms of an ongoing benefit plan, there is no *present* obligation to provide the benefits until communication of the plan of termination. The Board concluded that until this point the employer has the discretion to avoid paying termination benefits and, therefore, a liability does not exist.

BC17 Therefore, the Board decided that it should add a new recognition criterion to IAS 19 and specify that an entity does not have a present obligation to provide involuntary termination benefits (under either an ongoing or a one-time benefit plan) until it has communicated its plan of termination to the affected employees. The Board also decided to replace the present criteria relating to the plan of termination with those in SFAS 146. As noted, these criteria are very similar. Nonetheless, the Board concluded that it would ease convergence if they were identical.

Voluntary termination benefits

BC18 In US GAAP, most voluntary termination benefits are within the scope of SFAS 88 (and are not within the scope of SFAS 146) and are referred to as 'special termination benefits'. SFAS 88 specifies that an employer's obligation to provide voluntary termination benefits meets the definition of a liability when the employees accept the employer's offer of termination benefits. This is different from IAS 19, because IAS 19 specifies that the benefits are recognised when the entity is demonstrably committed to

provide those benefits. However, the Board concluded that in many instances the requirement of SFAS 88 would be closer to the principle underlying SFAS 146 (namely, that a liability is recognised when incurred). This is because until an employee accepts an entity's offer of voluntary termination of employment, the entity would typically have the discretion to withdraw the offer and, therefore, have no present obligation. Because of this and for the sake of convergence, the Board decided to amend IAS 19 to converge with SFAS 88.

BC19 The Board noted that the definition of special termination benefits in SFAS 88 specifies that the benefits are offered for only a short period of time. The Board decided that the short-term nature of the offer was important, because it noted that if the benefits for leaving service are made available for more than a short period, the employer has effectively established a new ongoing benefit plan and the employees would treat the benefits as part of their employment package. In other words, the benefits would be payable in exchange for the employees' services and, therefore, should be treated like any other post-employment benefit. Accordingly, the Board decided to amend the definition of termination benefits to clarify that benefits paid to encourage employees to leave service should be regarded as voluntary termination benefits under IAS 19 only if those benefits are made available for a short period.

Measurement

BC20 SFAS 146 specifies that one-time termination benefits should be measured at fair value, except when the liability is recognised over time. In such cases, the fair value measurement date is modified to the termination date, ie the fair value of the liability at termination date is recognised over the future service period.

BC21 The Board considered whether the measurement requirements of IAS 19 for termination benefits should converge with those of SFAS 146. However, it decided not to take this step, principally because it wanted to specify a measurement requirement that could be applied to all termination benefits, regardless of whether those benefits are provided through or outside an ongoing benefit plan. The Board noted that when termination benefits are provided through a post-employment defined benefit plan (for example, by providing an enhancement of retirement benefits) it would be unduly complex to specify that they should be measured at fair value. This

is because the effect of the changes to the plan arising from the termination of employment would need to be isolated, on an ongoing basis, from the remainder of the plan. Therefore, the Board decided that the measurement of such termination benefits should be consistent with the measurement of the underlying post-employment defined benefit plan.

BC22 Accordingly, the Board concluded that it should retain the existing measurement requirement in IAS 19 to discount termination benefits due more than 12 months after the balance sheet date. It acknowledged that this could result in measurement differences with US GAAP for one-time termination benefits within the scope of SFAS 146. However, it observed that most one-time termination benefits that are not recognised over a service period would be likely to vest relatively quickly and, hence, the effect of discounting might be immaterial.

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