

IASB press summary:

IAS 37 round-table discussions

Project overview

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is the International Financial Reporting Standard (IFRS) that prescribes the recognition, measurement and disclosure requirements for provisions, contingent liabilities and contingent assets.

The International Accounting Standards Board (IASB) has adopted a project with two objectives:

- (a) to analyse items within the scope of IAS 37 in terms of assets and liabilities, as defined in the IASB *Framework for the Preparation and Presentation of Financial Statements*,* and
- (b) to align the IAS 37 accounting guidance for restructuring costs with the equivalent accounting guidance in the US.

Most significantly, the proposed amendments to IAS 37 would require entities to recognise all transactions and events that meet the definition of a liability. Uncertainty about the amount or timing of the economic benefits required to settle a liability would be reflected in the measurement of that liability, but would not preclude recognition. The IASB believes that these amendments would improve financial reporting because some items that meet the definition of a liability are disclosed in the notes to the financial statements rather than recognised in an entity's balance sheet. The proposed amendments would also bring the IASB and the US national accounting standard-setter (the Financial Accounting Standards Board) one step closer towards their longer-term goal of convergence.

Round-table discussions

The IASB believes that the output of this project will be an important building block for other projects such as revenue recognition, government grants and leasing. It is therefore hosting five round-table discussions in Melbourne, London and Connecticut in November and

* An asset is a resource controlled by the entity arising from past events and from which future economic benefits are expected to flow to the entity.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of economic resources embodying economic benefits.

December 2006. More than 75 organisations from 12 countries are taking part in the discussions.

The round-table discussions focus on the proposed amendments to the recognition and measurement of liabilities within the scope of IAS 37. The main objective is to hear participants' views on the proposed amendments. But the discussions also provide the IASB with an opportunity to explain further the rationale underpinning its proposals. The IASB plans to consider the input from all of the round-table discussions at its meeting in January 2007. The discussions are expected to aid the IASB in planning the next steps in this project.

Project status

In June 2005 the IASB published an Exposure Draft (ED) of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*. The comment period ended on 28 October 2005 and the IASB received 123 comment letters.

In February 2006 the IASB agreed to redeliberate all of the amendments proposed in the ED. By October 2006 the IASB had redeliberated issues associated with the proposed scope, recognition and measurement principles. The IASB plans to redeliberate in 2007 the proposed disclosure requirements, the accounting for contingent assets and the amendments to the accounting guidance for restructuring costs. The project plan envisages that redeliberations will continue until the second half of 2007. Consistently with the IASB's previous statements, any amendments to IAS 37 will not be effective before 2009.

Summary of the proposed amendments to IAS 37

Scope and terminology

The IASB proposes to establish IAS 37 as the default standard for all liabilities that are not within the scope of other IFRSs. This would be achieved by extending the scope of IAS 37 and no longer using the term 'provision' to differentiate liabilities within the scope of IAS 37 from liabilities within the scope of other IFRSs.

Recognition

IAS 37 requires an entity to recognise a liability when (i) the definition of a liability is satisfied, (ii) it is probable (more likely than not) that an outflow of economic benefits will be required to settle the obligation, and (iii) the liability can be measured reliably. Items which satisfy the definition of a liability but do not meet criteria (ii) and (iii) are described as ‘contingent liabilities’ and disclosed in the notes to the financial statements.

The IASB proposes to omit the probability recognition criterion (criterion (ii)). It believes that the criterion may cause an entity to exclude from its balance sheet useful information about items that satisfy the definition of a liability. Moreover, the criterion creates tension with the measurement guidance in IAS 37. This guidance requires an entity to consider *all possible outcomes* in the measurement of a liability, regardless of whether each possible outcome is ‘more likely than not’. Therefore any uncertainty about the outflow of economic benefits required to settle a liability is captured in measurement. A separate probability based recognition criterion is not required.

Many constituents object to this proposal because the IASB *Framework* includes a separate probability recognition criterion. The IASB has therefore reconsidered but tentatively affirmed its proposal for the following reasons:

- other IFRSs do not apply a probability recognition threshold. For example, IAS 19 *Employee Benefits* does not permit an employer to delay the recognition of a liability for long-service leave until it is ‘more likely than not’ that an employee will complete *x* years service.
- a probability recognition criterion might result in inconsistent accounting for identical liabilities within the scope of IAS 37. For example, a retailer would not recognise a liability arising from a single product warranty if it is 30 per cent likely that a fault is reported during the warranty period. But the same retailer would recognise a liability if it had issued one hundred identical product warranties (even though it remains 30 per cent likely that a fault is reported for each individual product) because it is ‘more likely than not’ that at least one product will develop a fault during the warranty period.
- a probability recognition criterion creates a ‘cliff-hanger’. For example, an entity facing a lawsuit in which it has 55 per cent chance of losing at a cost of \$1 million and a 45 per cent chance of winning at a cost of \$nil would recognise a liability of

\$1 million. But if the percentages were reversed (and there is a 55 per cent chance that the entity will win), no liability is recognised.

The IASB also proposes eliminating the term ‘contingent liability’ from IAS 37. This is because the *Framework* states that the existence of a present obligation is an essential characteristic of a liability. A *present* obligation cannot be contingent on a future event therefore by definition, a liability cannot be contingent.

Measurement

IAS 37 requires an entity to measure a liability using its ‘best estimate of the expenditure required to settle the present obligation at the balance sheet date’. But the meaning ‘best estimate’ is not well understood, resulting in confusion and inconsistent application. The IASB proposes addressing this issue by replacing ‘best estimate’ with the more precise explanation taken from the amplifying text of IAS 37 - ‘the amount an entity would rationally pay to settle the obligation at the balance sheet date or transfer it to a third party at that time’.

Moreover, the IASB noted that the detailed measurement guidance in IAS 37 is not always consistent with the principle described above. Specifically, IAS 37 states that the ‘individual most likely outcome’ might be the best estimate of a single obligation. But the counterparty and/or a third party would consider all possible outcomes (not just the individual most likely outcome) in determining the amount an entity would have to pay to settle or transfer a liability on the balance sheet date. The IASB therefore proposes using probability-weighted cash flows (the approach currently used to measure portfolios of similar obligations) to measure all liabilities within the scope of IAS 37. Many constituents are concerned that it will be difficult to apply this proposal in practice. The IASB has therefore agreed to provide more application guidance.

Contingent assets

Consistently with its proposal to eliminate the term ‘contingent liability’, the IASB proposes to eliminate the term ‘contingent asset’. The IASB also proposes accounting for items previously described as contingent assets that satisfy the *Framework*’s definition of an asset in accordance with IAS 38 *Intangible Assets* rather than IAS 37.

Other amendments

The IASB believes that the following proposed amendments would align the IAS 37 guidance on the recognition of specific liabilities more closely with the equivalent US guidance:

- amend the definition of a constructive obligation to clarify that the actions of the entity must result in other parties having a valid expectation that they can reasonably rely on the entity to discharge its responsibilities.
- provide additional guidance on onerous contracts.
- revise the accounting guidance for restructuring costs to specify that a liability for a restructuring cost is only recognised when that cost satisfies the definition of a liability.
- provide specific accounting guidance for costs often associated with a restructuring including employee termination benefits and contract termination costs.

Further information

Further information on the proposed amendments to IAS 37, the round-table discussions and the project status is available on the IASB Website:

<http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities/Liabilities.htm>

Press enquiries

Warren McGregor, IASB member
telephone: +61 (0)3 9707 0449 or +61 (0)417 340 664 (mobile)
email: wmcgregor@iasb.org

Elizabeth Hickey, Director of Technical Activities, IASB
telephone: +44 (0)20 7246 6458 (office) or +44 (0)777 551 3663 (mobile)
email: ehickey@iasb.org

Sarah Broad, Project Manager, IASB
telephone: +44 (0)20 7246 6465
email: sbroad@iasb.org

Notes to Editors

About the IASB

The International Accounting Standards Board (IASB), based in London, began operations in 2001. Contributions collected by its Trustees, the IASC Foundation, from the major accounting firms, private financial institutions and industrial companies throughout the

world, central and development banks, and other international and professional organisations fund the operations of the IASB.

The 14 Board members (12 of whom are full-time) are drawn from nine countries and have wide international experience and a variety of functional backgrounds. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.