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ICAEW REP 11/05

PROPOSED AMENDMENTS TO IAS 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS AND IAS 19 EMPLOYEE BENEFITS

Memorandum of comment submitted in October 2005 by the Institute of Chartered Accountants in England and Wales, in response to International Accounting Standards Board exposure drafts Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits, published on 30 June 2005

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the exposure draft *Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*, published by the International Accounting Standards Board on 30 June 2005.

WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 125,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

IAS 37 *PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS*

MAJOR ISSUES

Convergence and consistency

4. In general, we see no need for the IASB to have addressed this standard at this time. While we would not disagree with the need to explore and rationalise the conceptual basis of IAS 37, we are not aware of evidence to suggest the existing standard causes difficulties in practice or results in inadequate financial reporting. Also, while we note the Board's references to US literature within the Basis for Conclusions, we are opposed to any attempt to converge to separate US rules rather than a clear principle; since US GAAP does not set out a clear principle that links its various rules on this matter, it seems more likely that any change will increase rather than reduce GAAP differences. Neither do we see proposed changes to the treatment of contingencies in a business combination in IFRS 3 as requiring consequential changes to IAS 37. Indeed, the proposed changes to IAS 37 would appear to result in two anomalous situations: firstly, that while non-financial liabilities which are difficult to measure would be stated at fair value, many financial liabilities which are more reliably measured would be at amortised cost; secondly, that most non-financial assets acquired in a business combination would not be subsequently remeasured to fair value, whereas non-financial liabilities would be remeasured.

Probability used for measurement, not recognition

5. The exposure draft proposes that the probability recognition criterion should be withdrawn and that probability should be used to measure the liability. We oppose this. Firstly, as set out in paragraph 8 below, we do not agree with the proposed removal of contingencies. Secondly, as set out in paragraph 9 below, we do not agree that probability is a suitable basis for measurement of individual obligations. Thirdly, as explained in paragraph 16 below, we are not convinced that a conditional obligation is necessarily a liability. We believe that the information provided to users under the new proposals will be potentially inferior to that currently provided under IAS 37, for example, there will be no qualitative disclosure of risks that do not qualify as non-financial liabilities. At the moment, in practice, an entity does not recognise a potential liability that will probably not arise at all, but recognises 100 per cent of the expected cost of settling a liability that probably will arise, together with very important qualitative explanations. As noted in BC81, this approach to measurement may not reflect the Board's intentions of reflecting expected cash flows, although we suspect there will be little difference in practice as a company will consider various outcomes, including the likelihood of settlement, and reflect this expected cash flow. However, in principle, estimating the probability that an event will occur is inherently unreliable, and applying that percentage to the expected cash flow if it does occur, will generally not result in the expected future cash flow except when applied to statistically significant populations. Where the probability is less than 50%, we prefer the present approach of measuring the outcome at its most likely amount, which is nil together with qualitative disclosure of the risks involved. By allowing companies to adjust provisions based on changes to unreliable assessments of probability, the Board may increase scope for manipulation.

SPECIFIC QUESTIONS

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?

6. We agree that IAS 37 should ultimately become a default standard for these liabilities. However, we do not believe that it would be appropriate to move in this direction at present. For example, performance obligations could be seen

to comprise a non-financial liability, but we do not think any change in the treatment of performance obligations should be contemplated in advance of the revenue recognition project being finalised. In view of the uncertainties as to scope, it would be helpful if the IASB were to outline which additional types of liability it believes will be caught by the proposal, and which will not.

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

7. We agree with not using provision as a defined term.

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?

8. We do not agree with eliminating the term 'contingent liability'. It is important to retain the concept of a contingency for items that are not already obligations. We understand the possible ambiguity of the term, in that it

describes an item that might turn out to be a liability rather than a particular type of liability. However, we are not aware that this causes problems in practice. Moreover, we suggest that the term ‘non-financial liability’ also has the potential for confusion, in that it embraces a wider set of items than contingencies (such as performance obligations).

(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?

9. We do not agree that when an unconditional obligation is contingent on uncertain future events, a liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur). Under current practice, an event that is more likely than not to occur will be recognised at the expected cash outflow, whereas an event that is likely not to occur will not be recognised at all. Note-disclosure provides the user with information to make judgements about the amount recognised (or not). This use of probability to determine recognition is consistent with the Framework and well understood by preparers and users.

10. We agree with the Alternative view, and in particular with paragraph AV4, 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.’

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?

11. We do not agree with eliminating the term 'contingent asset'. Under current practice, a contingent asset is a 'possible asset' that is not recognised until it ceases to be contingent: ie, when realisation of related income is 'virtually certain'. While we can see that the Board is seeking to move closer to the Framework, we nevertheless see that the present approach, in conjunction with the qualitative information disclosed in accordance with the standard, works well in practice.

(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?

12. We do not agree that items previously described as contingent assets should be dealt with in accordance with IAS 38. This seems to be a case of the Board seeking to push an item into a standard which, as currently drafted, does not provide adequate guidance on the recognition and measurement of contingent assets. As set out above, we believe that current practice in relation to contingent liabilities and contingent assets is satisfactory and does not need to be revised. We are not clear what evidence the IASB has to suggest that current practice is unsatisfactory. Furthermore, we note that this proposal would diverge from US GAAP.

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?

13. We are not clear why the proposed amendment to the definition of a constructive obligation (to the effect that other parties must be able to 'reasonably rely on' the entity discharging its responsibilities) has the material effect suggested by the IASB. If the IASB's intention is, as implied by the Basis for Conclusions, to exclude from recognition some constructive

obligations that would currently be recognised, then the drafting of the standard itself needs to be more explicit. We would not oppose some tightening of the definition but believe that the impact of the change in wording should be more self-evident.

(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?*

14. As set out above, the standard does not give sufficient guidance on the implications of the need for other parties to be able to 'reasonably rely on' the entity to discharge its responsibilities, rather than, as at present, their having 'a valid expectation' that it will do so.

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?

15. We do not agree that the probability recognition criterion should be withdrawn. The current approach under IAS 37 has proved itself in practice, and we question why a fundamental change of concept is thought necessary.

16. Furthermore, we do not agree with the IASB's conclusion that an unconditional obligation to stand ready to honour a conditional obligation is necessarily a liability; for example, we do not consider that the receipt of a frivolous legal claim should result in any provision other than the costs of defending the claim. According to the Framework, a liability entails an expectation of an outflow of economic benefits. We do not believe that 'standing ready' of itself involves a flow of economic benefits. The issuer of a product warranty is not providing a service for the duration of the contract, it is agreeing to provide the service if required. The service obligation may never be invoked, and there is no outflow of economic benefits unless and until it is invoked.

17. If such a change is to be proposed, it should first be discussed in the context of a debate on the Framework. We note that paragraph BC112 of current IFRS 3 implies that the IASB is committed to considering the role of probability in the context of a project on the conceptual framework. Furthermore, as a matter of principle, we believe that before proposing any conceptual change to an IFRS, the IASB should propose and debate an amendment to the Framework itself.

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?

18. We do not agree with the proposed amendments to the measurement requirements. As set out above, under current practice, an event is recognised on the basis of whether or not it is probable that it will occur. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability, although it is necessary to consider other possible outcomes. For single-item and other small populations, the best estimate of expected cash flow is 100 percent of the likeliest outcome, which may be less than 100% of any claim. Additional disclosure provides the user with qualitative information with which to make judgements about the numbers. The proposed measurement requirements:

- will call for more precise information about probability and expected future cash flows than are easily available in practice; and
- will result in an 'expected value' being disclosed in respect of single liabilities, when in our view such a value is only valid in respect of large populations of potential liabilities.

20. We would agree that, for example, where it is expected that 60 per cent of large number of claims are likely to be paid, it is correct to recognise 60 per cent of the total amount, being 100% provision for 60% of the claims. We do not agree that if it is 60 per cent probable that a large claim will result in a payment, then 60 per cent of the claim should be recognised. The amount recognised on this basis can never reflect the actual cash flow resulting, which will be the amount expected to be paid in settlement.

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?

21. No. We prefer the requirement in the current IAS 37 that the reimbursement must be virtually certain. The proposed amendment transfers application of the probability criterion from recognition to measurement.

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?

22. Yes.

(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?

23. No. Measurement of the liability should reflect the best estimate of economic outflows, as for contingencies generally, and the best estimate should be entity-specific.

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

24. Yes.

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?

25. Yes. In fact, we are not clear that this will make a significant difference in practice, because we believe that there will often be a constructive obligation

to implement at least the early stages of a restructuring as soon as the restructuring is commenced.

(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?

26. As we are not altogether clear why the IASB believes that its proposal will change practice, there may be a case for further interpretation.

IAS 19 *EMPLOYEE BENEFITS*

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?

27. We agree.

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?

28. No. A constructive obligation will arise in respect of voluntary termination benefits before the employees accept the offer, and should be recognised accordingly. The nature and timing of the constructive obligation will be different in different jurisdictions. It also appears to be inconsistent with the IASB's proposed changes to IAS 37, in that there is a stand-ready obligation once an offer has been made.

29. We agree with the proposals in respect of involuntary termination benefits.

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?

30. We agree.

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