First Pre-ballot Draft of “Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits”

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Exposure Draft of Proposed

AMENDMENTS TO

IAS 37
PROVISIONS, CONTINGENT LIABILITIES AND
CONTINGENT ASSETS

IAS 19
EMPLOYEE BENEFITS

Comment to be received by X MONTH 2004
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Proposed Amendments to IAS 19 *Employee Benefits*

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Introduction

1. This Exposure Draft has been issued by the International Accounting Standards Board as a result of two of the Board’s projects: the Short-term Convergence project and the second phase of the Business Combinations project.

2. The Short-term Convergence project being undertaken jointly with the Financial Accounting Standards Board (FASB) in the United States has the objective of reducing differences between International Financial Reporting Standards (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. It is one strand of the Board’s broader objective of convergence of accounting standards around the world that underlies much of the Board’s work.

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 19 Employee Benefits for termination benefits and those proposed to the requirements in IAS 37 Provisions, Contingent Liabilities and Contingent Assets for constructive obligations, onerous contracts and restructuring provisions arise 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 achieve substantial convergence with the recognition requirements of SFAS 146.

4. Most of the remaining proposed amendments to IAS 37 are to the definitions of contingent assets and contingent liabilities. These amendments reflect decisions in the second phase of the Business Combinations project relating to the treatment in a business combination of contingencies of an acquiree. The amendments have required some re-ordering of the existing recognition requirements of IAS 37 as well as a reconsideration of the Standard’s probability recognition criterion. Given that these amendments have been 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 Business Combinations. If confirmed in a Standard, the proposals in this Exposure Draft would have an effective date of X Month 200X, the same as the amended IFRS 3 Business Combinations.

5. The Board emphasises that although these amendments reflect a new analysis of contingent assets and liabilities, and have required changes to the structure of the Standard, they should not significantly alter either the recognition or disclosure of many items from the present version of IAS 37. However, in some instances, present obligations that previously were only disclosed in the financial statements will now be recognised.

6. The Board’s intention while developing this Exposure Draft was to reflect only those changes related to its decision in the Short-term Convergence project and the second phase of the Business Combinations project, and not to reconsider all of the requirements in IAS 19 and IAS 37. In particular, the Board has not sought convergence of the measurement objective of IAS 37 with that of
SFAS 146; however, it has taken the opportunity to make some improvements to the measurement guidance.

Invitation to comment

7. The Board invites comments on all the changes proposed in the Exposure Draft and would particularly welcome answers to the questions set out 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 these Standards not proposed for change.

8. Comments should be submitted in writing so as to be received no later than **XX MONTH 2004**. Until the revised Standard becomes effective, the requirements of the current versions of IAS 37 and IAS 19 remain in force.

Presentation of the document

9. This Exposure Draft presents for each of the proposed revised 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 marked-up copy of the full text of IAS 37 and (b) a marked-up copy of the amended paragraphs of IAS 19. The revised texts incorporate all amendments to those Standards made by other revised and new Standards. [The amendments to IAS 37 proposed in the XX 2004 Exposure Draft are also presented as marked-up text.]

- A Basis for Conclusions. This section presents the basis for the Board’s conclusions on major issues.

- Consequential amendments to other Standards and SIC Interpretations.

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1 Staff note: sentence only applicable if any relevant EDs are outstanding when this ED published.

2 Staff note: this section has not yet been prepared.
PROPOSED AMENDMENTS TO

IAS 37
PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

[notes: For the purpose of this Exposure Draft, the new text is underlined and the deleted text is struck through. [The text incorporates all proposed amendments from the XX 2004 Exposure Draft XX.] ]
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, where applicable, provide a suggestion for alternative wording.

Question 1 – Contingent liabilities

The Exposure Draft proposes that a contingent liability should be defined as a conditional obligation.

The Exposure Draft explains that a contingent liability, by itself, does not satisfy the definition of a liability because the obligation, being conditional on the occurrence (or non-occurrence) of an uncertain future event, is not a present obligation. However, the Exposure Draft highlights that in many cases contingent liabilities are accompanied by present obligations that satisfy the definition of a provision. In such cases, the provision accompanying the contingent liability is accounted for in the same way as a provision that does not accompany a contingent liability.

(a) Do you agree with the proposed amendment to the definition of a contingent liability? If not, why not?

(b) Do you agree that contingent liabilities (as newly defined) are in many cases accompanied by present obligations that satisfy the definition of a provision? If not, why not?

Question 2 – Contingent assets

Consistently with the definition of a contingent liability, the Exposure Draft proposes that a contingent asset should be defined as a conditional right.

The Exposure Draft explains that a contingent asset, by itself, does not satisfy the definition of an asset but highlights that in many cases contingent assets are accompanied by unconditional rights that satisfy the definition of an asset. The accounting for such assets is not dealt with in this Exposure Draft; however, the Exposure Draft explains that such assets are accounted for in accordance with IAS 38 Intangible Assets or IAS 39 Financial Instruments: Recognition and Measurement, depending on the nature of the asset.

(a) Do you agree with the proposed amendment to the definition of a contingent asset? If not, why not?

(b) Do you agree that contingent assets (as newly defined) are accompanied by unconditional rights that satisfy the definition of an asset? If not, why not?

Question 3 – 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 that they can “reasonably rely” on the entity to discharge its responsibilities. The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation.
(a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not?

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

Question 4 – Probability recognition criterion

The Exposure Draft proposes omitting the probability recognition criterion (former paragraph 14(b)) from the Standard because, in all cases, the criterion is satisfied. Items that satisfy the definition of a provision are therefore recognised unless they cannot be measured reliably.

The Basis for Conclusions notes that in many cases while there may be uncertainty about the amount and timing of the resources required to settle the provisions, there is little or no uncertainty that settlement will required some outflow of resources. An example would be an entity that has an obligation to decommission plant or to restore previously contaminated land. The Basis for Conclusions also notes that in some other cases, the probability recognition criterion is presently applied to what under these proposals would now be regarded as a contingent liability (conditional obligation) rather than a present obligation. For example, an entity that issues a product warranty presently considers whether it is probable that the product will develop a fault (ie whether the entity’s conditional obligation will probably result in an outflow of economic resources), rather than whether its present obligation to provide a service for the duration of the contract will probably result in an outflow of economic resources.

The Basis for Conclusions highlights that it is the present obligation that should be considered for recognition and not the contingent liability. It also notes that under Framework the outflow of resources required to settle a provision is not just the giving up of cash or other assets but can involve the entity providing a service. Therefore, for example, an entity that has issued a product warranty has satisfied the probability recognition criterion because it is certain (and not just probable) that there will be an outflow of resources from the provision of services regardless of the probability of a claim arising under the warranty.

Do you agree with the analysis of the probability recognition criterion and therefore with the reasons for omitting the probability recognition criterion from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties and other provisions that accompany contingent liabilities?

Question 5 – Measurement

The Exposure Draft proposes that provisions should be measured at “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.” The Exposure Draft explains that measuring single obligations at the individual most likely outcome would not necessarily be consistent with this requirement.

Do you agree with the proposed amendments to the measurement requirements? If not, why not?

Question 6 – Reimbursements
The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the resources required to settle a provision, the right should be recognised as an asset if the right can be measured reliably.

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

**Question 7 – Onerous contracts**

The Exposure Draft proposes that when a contract becomes onerous as a result of the entity’s own action, the provision should not be recognised until the action has occurred. 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 provision is recognised when the entity ceases to use the property. In addition, the Exposure Draft clarifies 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 it intends to enter into a sublease.

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

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

**Question 8 – Restructuring provisions**

The Exposure Draft proposes that a management or board decision to restructure, even if accompanied by a general announcement, does not give rise to a constructive obligation (as newly defined) to restructure. The Standard requires provisions for costs associated with a restructuring to be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has satisfied the definition of a provision (unless the provisions cannot be measured reliably).

The Standard proposes guidance (or provides cross-references to other Standards) for applying its principles to the following costs that are often associated with a restructuring:

- termination benefits;
- costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity; and
- costs to terminate a contract before the end of its term.

(a) Do you agree that a management or board decision to restructure, even if accompanied by a general announcement, does not give rise to a constructive obligation at the balance sheet date?

(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:

Contingent liabilities

- IAS 37 defines a contingent liability as a possible obligation or a present obligation that is not recognised because it fails the Standard’s recognition criteria (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 the recognition of contingent liabilities but requires their disclosure, unless the possibility of any outflow of economic resources in settlement of the contingent liability is remote. The Exposure Draft proposes that:
  - a contingent liability should be defined as a conditional obligation and clarifies that because it is not a present obligation, it is not a liability.
  - in many cases, the existence of a contingent liability points to the existence of an accompanying present obligation that satisfies the definition of a provision. A provision accompanying a contingent liability is recognised, measured and disclosed in the same way as a provision that does not accompany a contingent liability.
  - a provision that fails to qualify for recognition is an unrecognised liability rather than a contingent liability. The unrecognised liability is disclosed.

- The purpose of these amendments is to clarify that only present obligations (rather than possible obligations) of the entity can give rise to liabilities or provisions, and that a provision that fails to qualify for recognition under this draft Standard is nonetheless a liability.

Contingent assets

- IAS 37 defines a contingent asset as a possible asset. The Standard does not permit the recognition of contingent assets but requires their disclosure if an inflow of economic benefits is probable. The Exposure Draft proposes that:
  - a contingent asset is a conditional right and is therefore not an asset.
  - in many cases, the existence of a contingent asset also points to the existence of an unconditional right that satisfies the definition of an asset. An asset accompanying a contingent asset is accounted for under IAS 38 Intangible Assets or IAS 39 Financial Instruments: Recognition and Measurement depending on the nature of the asset.

- The purpose of the amendment is to clarify that only resources controlled by the entity as a result of a past transaction or event (rather than possible assets) can give rise to assets.

Constructive obligations

Note: Staff has followed the style of Improvements and the ED of IASs 36/38 (that accompanied IFRS 3). However, we note that this section duplicates a lot of the material in the previous section.
• IAS 37 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 certain responsibilities and as a result the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. The Exposure Draft proposes:
  o 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.
  o additional guidance to determine 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 to the Standard apply this probability recognition criterion to what the Exposure Draft now analyses as conditional obligations (contingent liabilities). 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 contingent liability will become a present obligation and hence 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 present obligation rather than the contingent liability (conditional obligation). As a result, the Basis for Conclusions highlights that the probability recognition criterion is in fact always satisfied and 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 explained 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 used as a measurement method when a large population of items is involved, the Standard states that the best estimate of single obligations may be the individual most likely outcome. The Exposure Draft proposes:
  o to eliminate the notion of best estimate, and instead use the current explanation of best estimate (ie 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) as the measurement requirement of the Standard.
  o to emphasise that expected value is a measurement method that may be appropriate for measuring both a large population of items and single obligations, and that measuring single obligations at their individual most
likely outcome is not necessarily consistent with the Standard’s measurement objective.

- to clarify that the discount rate used in measuring provisions both initially and subsequently is a current rate.

**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 a right to receive reimbursement, that right should be recognised as an asset if it can be measured reliably.

**Onerous contracts**

- Under IAS 37 an onerous contract is one in which the unavoidable costs of meeting the obligation under the contract exceed the economic benefits expected to be received under it. The entity recognises the present obligation under the contract as a provision. The Standard provides no further guidance about when the provision should be recognised. The Exposure Draft proposes:
  - additional recognition guidance to specify that when a contract becomes onerous as a result of an entity’s own action, the provision should not be recognised until that action has occurred.
  - to clarify 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**

- Under IAS 37 an entity that 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. It therefore recognises a provision for the direct expenditures arising from the restructuring. The Exposure Draft proposes:
  - revising the application guidance for restructuring provisions to clarify that a management or board decision to restructure, even if generally announced, does not by itself create an obligation.
  - to provide specific guidance for the accounting for costs that are often incurred in a restructuring as follows:
    - the cost of employee termination benefits is recognised in accordance with IAS 19 Employee Benefits.
• a provision 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 contract becomes onerous.

• the cost of terminating a contract before the end of its term is recognised when the contract becomes onerous.
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Provisions, Contingent Liabilities and Contingent Assets

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APPENDICES
A. Tables – Provisions, Contingent Liabilities, Contingent Assets and Reimbursements
B. Decision Tree
C. Examples: Recognition
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APPENDIX:
Amendments to Other Pronouncements

BASIS FOR CONCLUSIONS

ILLUSTRATIVE EXAMPLES
Objective

1. The objective of this [draft] Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

Scope

1.2. This [draft] Standard shall be applied by—

(a) those resulting from executory contracts, except where if the contract is onerous; and

(b) loan commitments that are excluded from the scope of IAS 39 Financial Instruments: Recognition and Measurement, except if the loan commitment is onerous; and

(c) those covered by another Standard.

2. This [draft] Standard does not apply to financial instruments (including guarantees) that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement.

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. This [draft] Standard does not apply to executory contracts unless they are onerous.

4. [Deleted]

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3 Staff note: this paragraph (and paragraph 4) were deleted as a result of a consequential amendment in IFRS4 and not this project, ie the current bound volume presently says “Deleted”.
5.4. Where another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this [draft] Standard. For example, IFRS 3 Business Combinations addresses the treatment by an acquirer of contingent liabilities assumed in a business combination. Similarly, certain types of provisions are also addressed in Standards on:

(a) construction contracts (see IAS 11 Construction Contracts);

(b) income taxes (see IAS 12 Income Taxes);

(c) leases (see IAS 17 Leases). However, as IAS 17 contains no specific requirements to deal with operating leases that have become onerous, this [draft] Standard applies to such cases;

(d) employee benefits (see IAS 19 Employee Benefits); and

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

(f) financial instruments, including guarantees (see IAS 39 Financial Instruments: Recognition and Measurement).

5.5. Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantees or 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 practical guidance on the application of the recognition criteria. This [draft] Standard does not change the requirements of IAS 18.

5.6. This [draft] Standard defines a provisions as liabilities of uncertain timing or amount. In some countries the term ‘provision’ is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this [draft] Standard.

5.7. Other Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this [draft] Standard. Accordingly, this [draft] Standard neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

5.8. This Standard applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by IFRS 5 Non-current Assets held for Sale and Discontinued Operations.

Definitions

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

A constructive obligation is a present obligation that derives from a past event through an entity’s actions where:

(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 certain particular responsibilities; and
(b) as a result, the entity has created a valid expectation on the part of in those other parties that it will discharge they can reasonably rely on it to discharge those responsibilities.

A contingent asset is a possible asset conditional right that arises from past events and whose existence will be confirmed only by from which future economic benefits may flow based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

A contingent liability is

(a) a possible conditional obligation that arises from past events and whose existence will be confirmed only by that may require an outflow of resources embodying economic benefits based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

A legal obligation is an present obligation that derives from a past event through:

(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.

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

A provision is a liability of uncertain timing or amount.

A restructuring is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an entity; or

(b) the manner in which that business is conducted.

**Distinguishing Provisions and from Other Liabilities**

A provision is defined as a liability of uncertain timing or amount. Provisions are therefore a subset of liabilities. Most liabilities involve a degree
of uncertainty about the amount or timing of the future outflow of economic resources that will be required to settle them. However, for liabilities other than provisions can be distinguished from other liabilities such as trade payables and accruals because there is this uncertainty is less significant than for a provision about the timing or amount of the future expenditure required in settlement. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) For example, accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation holiday pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

**Relationship between Provisions and Contingent Liabilities**

12. In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term ‘contingent’ is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. In addition, the term ‘contingent liability’ is used for liabilities that do not meet the recognition criteria.

13. This Standard distinguishes between:

(a) provisions – which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

(b) contingent liabilities – which are not recognised as liabilities because they are either:

(i) possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

(ii) present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

**Recognition**
Provisions

14. [moved to paragraph 23]

Present Obligation Satisfying the definition of a liability

15. In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

16. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a law suit, it may be disputed whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the balance sheet date, the entity recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the balance sheet date, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86).

Past Event

10. Provisions are a subset of liabilities. Therefore, items are considered for recognition as provisions under this [draft] Standard only if they satisfy the definition of a liability in the Framework.

11. An essential characteristic of a liability is that the entity has a present legal or constructive obligation arising from a past event. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event a present obligation to exist, it is necessary that the entity has little or no realistic alternative discretion to avoid settling the obligation created by the past event. This is the case only:

(a) where if the settlement of the obligation can be enforced by law (ie a legal obligation exists); or

(b) in the case of a constructive obligation, where if the event (which may be an action of the entity) creates valid expectations in other parties that they can reasonably rely on the entity will discharge the obligation.

12. Although it will generally be evident whether an entity has a legal obligation, more judgement is required to determine whether an entity has a constructive obligation, especially when determining whether other parties can reasonably rely on the entity to discharge the obligation. In general, other parties can reasonably rely on the entity to discharge the obligation only if:

(a) the entity has indicated to other parties that it will accept certain 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.

In some jurisdictions, settlement of constructive obligations can be enforced by law under the doctrine of promissory estoppel.

18. Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity’s balance sheet are those that exist at the balance sheet date.

13. In determining whether a liability exists at the balance sheet date, an entity takes account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

14. It is only those present obligations arising from past events existing independently of an entity’s future actions (ie the future conduct of its business) that are recognised as provisions result in liabilities. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, for example, an entity recognises a provision has a liability for its obligation to decommission the decommissioning costs of 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 or no discretion to avoid settling that obligation.

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

16. A present obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a decision by the management of an entity or board decision does not give rise to a constructive present obligation at the balance sheet date, unless the decision has been communicated before the balance sheet date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that they can reasonably rely on the entity will to discharge its responsibilities.
17. 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, the causing of the damage will become an obligating event if a present obligation arises when if a new law requires the existing damage to be rectified or when if the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

18. Where details of a proposed new law have yet to be finalised, a legal obligation arises only when the legislation is virtually certain to be substantively enacted as drafted. For the purpose of this Standard, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases, it will be impossible to be virtually certain of the substantive enactment will not occur until the legislation is actually enacted.

Distinguishing Contingent liabilities from Liabilities

19. A contingent liability can be distinguished from a liability, because the obligation is conditional on the occurrence (or non-occurrence) of one or more uncertain future events not wholly within the control of the entity. Because the obligation is conditional it is not a present obligation and, by itself, does not give rise to a liability. Accordingly, a contingent liability is not recognised regardless of the likelihood of the occurrence (or non-occurrence) of the uncertain future event.

20. Although a contingent liability is itself not a liability, in many cases, the contingent liability is accompanied by an associated present obligation that satisfies the definition of a provision. In other words, the past events giving rise to the contingent liability also give rise to a provision. In such cases, an entity accounts for the provision accompanying the contingent liability.

21. For example, an entity that is involved in a lawsuit has a contingent liability relating to its conditional obligation to pay damages to the litigant. The obligation to pay damages is conditional because it depends on the outcome of the legal process. However, once the entity is involved in litigation it has little or no discretion but to perform as the court decides. It therefore has a present legal obligation to accept the court’s decision.

[no paragraph 22 in this draft]

23. Contingent liabilities should be distinguished from commitments to incur costs that the entity has the discretion to avoid. For example, a requirement under legislation or a contract of employment to pay termination benefits to an employee when terminating employment is not a contingent liability, because the uncertain future event (ie termination of employment) is within the control of the entity. Similarly, a legal requirement to rectify environmental damage does not give rise to a contingent liability for the costs of rectifying environmental damage that an entity expects to cause in the future, because the occurrence of the future damage is within the control of the entity.
Contingent Assets

24. In the same way that a contingent liability can be distinguished from a liability or provision, a contingent asset can be distinguished from an asset because the right to the future economic benefits is conditional on the occurrence (or non-occurrence) of one or more uncertain future events not wholly within the control of the entity. Therefore, a conditional right by itself does not satisfy the definition of an asset in the Framework and is not recognised.

25. Similarly to contingent liabilities, a contingent asset is sometimes accompanied by an associated asset. For example, the damages that an entity expects to receive as a result of pursuing a legal claim are a contingent asset, because the right to receive damages is conditional on a future event (ie the judgement of the court) not wholly within the entity’s control. The damages are therefore not recognised. However, the legal claim itself gives rise to an asset, being a present right to have the claim considered by the courts, which arises from the action the entity has performed to get to the point of pursuing its claim. That right meets the definition of an asset.

26. This [draft] Standard does not specify recognition, measurement or disclosure requirements for assets accompanying contingent assets. If the asset is a financial asset, it is accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement. Otherwise, the asset is a non-monetary asset without physical substance and, subject to satisfying the identifiability criterion in IAS 38 Intangible Assets, is an intangible asset accounted for in accordance with IAS 38.

Recognition

27. A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of unless the amount of the obligation provision cannot be measured reliably.

If these conditions are not met, no provision shall be recognised.

Probable Outflow of Resources Embodying Economic Benefits

23. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard, An outflow of resources or other event is regarded as probable if the event is more likely than not to occur, ie the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86 83).

The interpretation of ‘probable’ in this Standard as ‘more likely than not’ does not necessarily apply in other Standards.
24. Where there are a number of similar obligations (eg product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

**Reliable Estimate of the Obligation Measurement**

25. The use of estimates is an essential part of the preparation of financial statements and does not of itself undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most many other balance sheet items. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently determine a reliable to use in recognising measure a of the provision.

26. When there is a number of similar provisions (eg provisions resulting from product warranties or similar contracts) the measurement of the provision may be determined by considering the class of provisions as a whole.

27. In the extremely rare case where in which no reliable estimate can be made the provision cannot be measured reliably, a liability exists that cannot be recognised the provision does not qualify for recognition under this [draft] Standard. That liability In such cases, the provision is disclosed as an contingent unrecognised liability (see paragraph 86 74). The provision is recognised initially in the period in which it can be measured reliably.

**Contingent Liabilities**

28. An entity shall not recognise a contingent liability.

29. A contingent liability is disclosed, as required by paragraph 86, unless the possibility of an outflow of resources embodying economic benefits is remote.

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

31. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

**Contingent Assets**

32. An entity shall not recognise a contingent asset.

33. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An
example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

33. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

34. A contingent asset is disclosed, as required by paragraph 89, where an inflow of economic benefits is probable.

35. Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset (see paragraph 89).

**Measurement**

**Best Estimate Rationally Pay to Settle or Transfer**

36. The amount recognised as a provision shall be measured at the best estimate of the expenditure required that an entity would rationally pay to settle the present obligation at the balance sheet date or to transfer it to a third party at that time.

37. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the balance sheet date. However, the estimate of the amount that an entity would rationally pay to settle or transfer an obligation gives the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

38. In some cases, contractual or other market evidence can be used to estimate the amount needed to settle or transfer a provision at the balance sheet date. However, in many cases, observable market evidence of the amount that the entity would rationally pay to settle the provision or to transfer it to a third party will not exist and a method of estimating this amount needs to be used.

39. Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is ‘expected value’. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.
33. One estimation method is to use an expected cash flow approach, in which multiple cash flow scenarios that reflect the range of possible outcomes are weighted by their associated probabilities.

**Example**

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of 1 million would result. If major defects were detected in all products sold, repair costs of 4 million would result. The entity’s past experience and future expectations indicate that, for the coming year, 75 per cent of the goods sold will have no defects, 20 per cent of the goods sold will have minor defects and 5 per cent of the goods sold will have major defects.

In accordance with paragraph 24, an entity assesses the probability of an outflow for the warranty obligations as a whole.

The expected value of the cost of repairs is:

\[(75\% \text{ of nil}) + (20\% \text{ of 1m}) + (5\% \text{ of 4m}) = 400,000\]

An entity places an offshore oil platform into service. The entity has a legal obligation to dismantle and remove the platform at the end of its useful life, which is estimated to be 10 years. The entity estimates that there is a 25 per cent probability that the cash flows involved in dismantling and remove the platform will be CU200,000, 50 per cent probability that they will be CU225,000 and 25 per cent probability that they will be CU275,000.

Under an expected cash flow approach, the cash flows used in measuring the provision for the obligation to dismantle and remove the platform are:

\[(25\% \times \text{CU200,000}) + (50\% \times \text{CU225,000}) + (25\% \times \text{CU275,000}) = \text{CU231,250}\]

40. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. For example, if an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

34. An expected cash flow approach is an appropriate estimation method for measuring both provisions for a class of similar obligations and a provision for a single obligation, because it is likely to be the basis of the amount that an entity would rationally pay to settle or to transfer the provision to a third party at the balance sheet date. In contrast, a provision for a single obligation measured at its individual most likely outcome would not necessarily represent the amount that the entity would rationally pay to settle or to transfer the provision.

* In this [Draft] Standard, monetary amounts are denominated in ‘currency units’ (CU).
The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

When an entity is estimating the amount of a provision that accompanies an associated contingent liability, the measurement of the provision reflects the amount and likelihood of the occurrence of the cash flows associated with the contingent liability. For example, in estimating a product warranty obligation, an entity considers the likelihood that claims will occur and the cash flows that will be required to meet those claims.

The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under IAS 12 *Income Taxes*.

**Risks and Uncertainties**

The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

In measuring a provision in accordance with paragraph 31, an entity shall include the effects of risks and uncertainties on the estimate of the amount expected to be required to settle the obligation.

Risk describes variability of outcome. A risk adjustment may increase typically increases the amount at which a liability is measured, relative to a measurement that does not include a risk adjustment. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, 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 provision.

Disclosure of the uncertainties surrounding the amount of the expenditure outflow of economic resources embodying economic benefits is made under paragraph 85 73(b).

**Present Value**

Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation. When an estimation method involving projections of future cash flows is used to measure a provision, the cash flows shall be discounted if the effect of the discounting is material.

Because of the time value of money, provisions relating to estimated cash outflows that arise soon after the balance sheet date are more onerous than those where cash outflows of the same amount arise later. Provisions Cash flows are therefore discounted, where if the effect is material.
47 43. The discount rate (or rates) used at each balance sheet date shall be 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

Future Events

48 44. Future events that may affect the amount required to settle an obligation shall be reflected in the amount measurement of a provision where if there is sufficient objective evidence that they will occur.

49 45. Expected future events may be particularly important in measuring provisions. For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to about the technology that will be available at the time of the clean-up. Thus it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

50 46. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be substantively enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Expected Disposal of Assets

51 47. Gains from the expected disposal of assets shall not be taken into account in measuring a provision.

52 48. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognises gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned.

Reimbursements

53 49. Where When the entity has a right to be reimbursed by another party for some or all of the expenditure transfer of resources required to settle a provision is expected to be reimbursed by another party, the right to reimbursement shall be recognised as an asset when, and only when, if it is virtually certain that reimbursement will be received if the entity settles the

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2 Further guidance on using cash flow information and present value in accounting measurements is contained in Appendix A to IAS 36 Impairment of Assets.
The reimbursement shall be treated as a separate asset. The amount recognised for the right to reimbursement shall not exceed the amount of the provision.

54. In the income statement, the expense relating to a provision may be presented net of the amount recognised for the right to reimbursement.

55. Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers’ warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly. Although the reimbursement itself is a contingent asset, the right to receive reimbursement satisfies the definition of an asset and is therefore recognised if it can be measured reliably.

56. In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected right to reimbursement is recognised as an asset when it is virtually certain that reimbursement will be received if the entity settles the liability if it can be measured reliably.

57. In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they are not included in the provision.

58. As noted in paragraph 29, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

59. The carrying amount of a provision shall be reviewed at each balance sheet date and adjusted to reflect the current best estimate amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed derecognised when the obligation is settled or cancelled or expires.

60. Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Use of Provisions

61. A provision shall be used only for expenditures for which the provision was originally recognised.

62. Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.
Application of the Recognition and Measurement Rules

Future Operating Losses

58. Provisions shall not be recognised for future operating losses.

59. Future operating losses do not meet the definition of a liability because there is no present obligation in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

60. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity tests these assets for impairment under IAS 36 Impairment of Assets.

Onerous Contracts

61. If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision. If the contract becomes onerous as a result of the entity’s own actions, the provision shall not be recognised until that action has occurred.

62. 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. Where events make such a contract onerous, the contract falls within the scope of this [draft] Standard and a liability exists which is recognised. Executory contracts that are not onerous are outside the scope of this [draft] Standard.

63. In some cases, contracts become onerous as a result of events outside the entity’s control. For example, a contract under which the entity must 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 has fallen below the contracted price. In other cases, the event that makes the contract onerous is an action of the entity. In such cases, the provision for the onerous contract is not recognised until the action of the entity occurs. For example, a contract may become onerous because the entity ceases to use the rights conveyed by that contract but continues to incur costs for its obligations under the contract. The entity therefore recognises a provision when it ceases using the rights conveyed by the contract.

64. This [draft] Standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. 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 unavoidable cost shall be determined by reference to the remaining lease rentals, 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.
Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see IAS 36 Impairment of Assets).

Restructuring

The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;
(b) the closure of business locations in a country or region or the 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) fundamental reorganisations that have a material effect on the nature and focus of the entity’s operations.

A provision for a cost associated with a restructuring is recognised only when the entity has incurred a liability and the general recognition criterion for provisions set out in paragraph 14 are met. A decision by the management of the entity to restructure, even if accompanied by a general announcement, does not give rise to a constructive obligation, because the entity has no obligation to other parties for the costs expected to be associated with the restructuring and has the discretion to avoid an outflow of economic resources. A cost associated with a restructuring is therefore recognised as a provision on the same basis as if that cost arose independently of a restructuring. Paragraphs 72-83 set out how the general recognition criteria apply to restructurings.

Costs that are typically associated with a restructuring include the following:

(a) termination benefits;
(b) costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity; and
(c) costs to terminate a contract before the end of its term.

A provision for termination benefits shall be recognised in accordance with the requirements of [draft] IAS 19 Employee Benefits relating to termination benefits. A provision for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity and for costs to terminate a contract before the end of its term shall be recognised in accordance with the requirements of this [draft] Standard relating to onerous contracts (see paragraphs 61-65).

A constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least:
   (i) the business or part of a business concerned;
   (ii) the principal locations affected;
   (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
   (iv) the expenditures that will be undertaken; and
(v) when the plan will be implemented; and
(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

73. Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (i.e. setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

74. For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

75. A management or board decision to restructure taken before the balance sheet date does not give rise to a constructive obligation at the balance sheet date unless the entity has, before the balance sheet date:
(a) started to implement the restructuring plan; or
(b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

[remainder of former paragraph moved to new paragraph 71]

76. Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of paragraph 72 are met.

77. In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (e.g. employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.

78. No obligation arises for the sale of an operation until the entity is committed to the sale, i.e. there is a binding sale agreement.

79. Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been
identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment, under IAS 36 Impairment of Assets. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

80. A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity.

81. Other costs associated with a restructuring provision does not include, but are not limited to, such costs as:

(a) retraining or relocating continuing staff;

(b) marketing costs to consolidate or close facilities; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring. An entity recognises liabilities for such costs when the obligation is incurred (generally, when goods or services associated with the activity are received).

71. If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the balance sheet date, disclosure is required under IAS 10 Events after the Balance Sheet Date, if the restructuring is material and non-disclosure could influence the economic decisions of users taken on the basis of the financial statements.

82. Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract as defined in paragraph 10.

83. As required by paragraph 51, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

84. For each class of recognised provision, an entity shall disclose a reconciliation of the carrying amount at the beginning and end of the period showing:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made incurred in the period—excluding increases to existing provisions;

(c) provisions amounts used (ie incurred and charged against the provision) settled during the period;

(d) unused amounts reversed during the period; and
(e) the increase changes during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate; and

(d) other adjustments to the amount of the provision (eg revisions in estimated cash flows required to settle or transfer the provision).

Comparative information is not required.

§73. An entity shall disclose the following for each class of recognised provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning about future events, as addressed in paragraph 48 44; and

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

§74. Unless the possibility of any outflow in settlement is remote, An entity shall disclose for each class of (i) unrecognised liability and (ii) contingent liability that is not accompanied by an associated provision and for which the possibility of any outflow of resources embodying economic benefits is not remote at the balance sheet date a brief description of the nature of the unrecognised or contingent liability at the balance sheet date and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 36-52 31-48;

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

(c) the possibility existence of any right to reimbursement.

§75. In determining which provisions, unrecognised liabilities or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs §73(a) and (b) and §74(a) and (b). Thus, it may be appropriate to treat as a single class of provision 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 that are subject to legal proceedings.

§88. Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by paragraphs §4.86 in a way that shows the link between the provision and the contingent liability.

§89. Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the balance sheet date, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-52.

90. It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.
94. Where If any of the information required by paragraphs 86-74 and 89 is not disclosed because it is not practicable to do so, that fact shall be stated.

92. In extremely rare cases, disclosure of some or all of the information required by paragraphs 84-89 72-75 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the recognised provision, unrecognised liability or contingent liability or contingent asset. 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.

Transitional Provisions

93. The effect of adopting this Standard on its effective date (or earlier) shall be reported as an adjustment to the opening balance of retained earnings for the period in which the Standard is first adopted. Entities are encouraged, but not required, to adjust the opening balance of retained earnings for the earliest period presented and to restate comparative information. If comparative information is not restated, this fact shall be disclosed.

94. [Deleted] 5

Effective Date

95. An entity shall apply this [draft] Standard becomes operative for annual financial statements covering periods beginning on or after 1 July 1999 Month 200X. Earlier application is encouraged. If an entity applies this Standard for periods beginning before 1 July 1999 Month 200X, it shall disclose that fact.

96. [Deleted]

Withdrawal of IAS 37 (revised 1998)


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5 Staff note: paragraph (and paragraph 96) deleted as a result of a consequential amendment in the Improvements Project.
Appendix A

Amendments to Other Pronouncements

The amendments in this appendix shall be applied for annual periods beginning on after 1 Month 200X. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period.

A1

[not yet drafted]
Basis for Conclusions

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

Introduction

BC1. This Basis for Conclusions summarises the 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 its recognition criteria. The Board has also taken the opportunity to make a limited number of other improvements to the Standard, in particular the requirements that address measuring a provision.

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 by an acquirer to the contingencies of an acquiree. Because of that consideration, and as detailed below, the Board proposes amending the definitions of contingent assets and contingent liabilities so that they are defined as conditional rights and conditional obligations. The Board also proposes a new analysis of items hitherto considered to be contingent assets and liabilities.

BC5. These proposals have required some changes to, and reordering of, the guidance formerly included in the recognition section of the Standard. They also have required a reconsideration of the application of the probability recognition criterion. Given the extent of the amendments, the Board decided that it would be more appropriate to include the revised definitions of contingent assets and contingent liabilities in this Exposure Draft rather than proposing them as consequential amendments accompanying the Exposure Draft of Proposed Amendments to IFRS 3 Business Combinations.

Definition of a contingent asset

BC6. 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 does or does not have an asset. For example, the Standard explains that an entity that is pursuing a claim through legal processes (a lawsuit), in which the outcome is uncertain, has a contingent asset. The lawsuit is therefore not recognised as an
asset until it is “virtually certain” that it will result in the realisation of income and can be regarded as an asset rather than a possible asset.

BC7. 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. Therefore, if the lawsuit was regarded as a contingent asset under IAS 37 at the date of the business combination (because it was not virtually certain to give rise to income), the acquirer would subsume its value into goodwill.

BC8. However, 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 under requirements at the standards level) 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 in fact be an asset and not a possible asset.

BC9. The Board therefore reconsidered the analysis of the lawsuit in IAS 37 and to do so, it turned to decisions it had reached in its ongoing Revenue Recognition project; in particular, its decisions relating to contractual rights and obligations.

BC10. 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 tentatively concluded that assets and liabilities arising from contracts derive only from unconditional rights and obligations and not from conditional rights and obligations. This is because a conditional right to future economic benefits is not a resource controlled by the entity and a conditional obligation that will result in an outflow of resources embodying economic benefits is not a present obligation. However, the Board also concluded that conditional rights and obligations in contracts are accompanied by associated unconditional rights and obligations. Therefore, while 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. For example, an entity that has an insurance contract is entitled to enjoy insurance coverage from the insurer, but it is not entitled to reimbursement for covered losses until it incurs such losses. The entity’s right to receive reimbursement for losses is therefore a conditional right, but its right to insurance coverage is an unconditional right. It is the unconditional right that satisfies the definition of an asset.

BC11. In its Revenue Recognition project, the Board’s tentative decisions about conditional and unconditional rights and obligations were made in the context of considering contractual rights and obligations. Nonetheless, the Board decided that the analysis of the relationship between conditional and unconditional contractual rights could be applied more widely and could be used to refine the analysis of a contingent asset in IAS 37. For example, the Board observed that a
lawsuit could be analysed into two rights: the entity’s conditional right to damages (conditional upon the outcome of the legal process) and its unconditional right to have its claim for recovery of the damage caused by the defendant considered by the courts. The Board therefore concluded that, during litigation, the possible damages are a contingent asset; the lawsuit itself, however, satisfies the definition of an asset.

BC12. The Board concluded that the foregoing would be a better analysis of the lawsuit than that provided by IAS 37, because it seeks to identify whether the entity controls a resource at the reporting date and hence has satisfied the definition of an asset. In other words, it requires an entity to determine whether or not it has satisfied the definition of an asset. In contrast, IAS 37 considers the possible inflow of benefits and uses a “virtually certain” recognition threshold to determine when those possible benefits have given rise to an asset.

BC13. The Board considered some other examples of contingent assets. For example, an entity that has made an application 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 agreed that the operating licence and the contract are the contingent assets, because they are contingent (or conditional) on a future event not wholly under the control of the entity (ie decision of the awarding authority, customer signing the contract). However, in both cases the entity has an asset. In the case of the licence application, the entity has an unconditional right to participate in the process of bidding for the licence. In the case of a pending customer contract, the entity has an unconditional right to the economic value of the developing contractual relationship.

BC14. The Board therefore decided that it would clarify that contingent assets are not in themselves assets but that the existence of a contingent asset points to the possible existence of an unconditional right that satisfies the definition of an asset. For consistency with its decisions in the Revenue Recognition project, the Board also decided to replace the notion of a ‘possible asset’ with the more precise term ‘conditional right’.

BC15. The Board decided that there was no need to provide recognition or measurement guidance in IAS 37 for an asset accompanying a contingent asset. The Board observed that such an asset would either be a financial asset or a non-monetary asset without physical form. The former would be accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement. The latter, subject to meeting the identifiability criterion, would be an intangible asset and therefore accounted for in accordance with IAS 38 Intangible Assets. The Board acknowledged that if the asset is an intangible asset and has not been acquired in a transaction, the requirements of IAS 38 impose a very high recognition threshold. However, the Board decided that it was outside the scope of this project to revisit the requirements in IAS 38.

Definition of a contingent liability

BC16. 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 in IAS 37 includes two notions. The first notion, a possible obligation, is symmetrical with the definition of a contingent asset and therefore
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. However, that obligation is not recognised as a provision 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.

Unrecognised present obligation

BC17. Although IAS 37 treats items that satisfy the two notions in the present definition of a contingent liability in the same way, the Board observed that combining two such distinct notions into one definition is potentially confusing. In particular, the Board reasoned that it is contradictory to describe a present obligation that does not qualify for recognition as a contingent liability, because, by its very nature, a present obligation is not a contingent obligation. That is to say, while the amount of the obligation, or the timing of its settlement, may be contingent upon uncertain future events, the obligation itself is not contingent.

BC18. The Board therefore concluded that the modifier ‘contingent’ should not apply to items that satisfy the definition of a liability and, as a consequence, decided that the notion of an unrecognised present obligation should be eliminated from the current definition of a contingent liability. The Board decided that provisions that fail to qualify for recognition under paragraph 27 of the Exposure Draft should be referred to as unrecognised liabilities rather than contingent liabilities. In the Board’s view, describing them in this way more appropriately captures the nature of the obligation. Consistently with the current requirements in IAS 37 for contingent liabilities, the Board decided that unrecognised liabilities should be disclosed.

Possible obligation

BC19. The Board then considered the notion of a possible obligation. 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.

BC20. 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 allocation 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 in the form of a reduced purchase price for the acquiree.

BC21. In the light of its decisions about contingent assets described above, the Board decided that it could refine its decision in IFRS 3, because it reasoned that its revised analysis of contingent (conditional) assets was also applicable to contingent liabilities.
BC22. The Board also noted that if it refined the analysis of contingent liabilities in IAS 37, there would be no need to specify different requirements for contingent liabilities and non-contingent liabilities in IFRS 3 and, further, all contingent liabilities 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 IFRS 3).

BC23. The Board therefore decided to amend IAS 37 and define a contingent liability as a conditional obligation rather than as a possible obligation and clarify that it is not a liability (because it is not a present obligation). The Board also decided to highlight the relationship between contingent liabilities (ie conditional obligations) and present (ie unconditional) obligations. In other words, the Board decided to explain that the existence of a contingent liability (conditional obligation) may point to the existence of an accompanying present obligation that satisfies the definition of a provision. That provision should therefore be accounted for in the same way as a provision that does not accompany a contingent liability.

BC24. For example, the Board observed that an entity that issues a guarantee (including a product warranty) has (i) a conditional obligation (contingent liability) to make a payment in the future if a specified triggering event occurs and (ii) an accompanying present obligation to perform over the term of the guarantee (because the entity is contractually obliged to honour the conditional obligation) that satisfies the definition of a provision. Similarly, in the case of an entity defending a lawsuit, the entity’s obligation to pay damages is a contingent liability because it is conditional upon the outcome of the lawsuit. However, the contingent liability is accompanied by an unconditional obligation, because the entity is obliged to perform as directed by the court.

BC26. The Board acknowledged that its constituents may have previously regarded some examples of contingent liabilities with accompanying provisions (eg product warranties) as examples of liabilities (or provisions). Indeed, the Board noted that many financial liabilities within the scope of IAS 39 could be analysed as two obligations: a contingent liability and an accompanying liability (or provision). The Board agreed that if the provision is identified and accounted for, there is no specific need to identify the two obligations. Nonetheless, the Board observed that in practice the contingent liability is sometimes more readily identifiable. 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 provision rather than to the contingent liability.

BC27. The key difference between the proposed approach to contingent liabilities in this draft Standard and that in IFRS 3 is that an entity determines whether or not the contingent liability has given rise to a present obligation that satisfies the definition of a liability before considering recognition and measurement. Under IFRS 3, the contingent liability itself was recognised, and the measurement of the contingent liability reflected the uncertainty about whether or not the contingent liability had given rise to a present obligation. The Board noted that the approach under this 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 US Financial Accounting Standards Board (FASB) on liabilities that have adopted a fair value measurement basis. For example, both SFAS 143 Accounting for Asset Retirement Obligations and SFAS 146 prohibit the recognition of obligations that do not satisfy the definition of a liability in FASB Concepts Statement No. 6 Elements of Financial Statements (Concepts Statement 6).

BC28. However, although the proposed approach is different to IFRS 3, the Board emphasises that its proposals should not be regarded as a reversal of the requirement under the present version of 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 the recognition of obligations in accordance with the present version of IFRS 3 and the proposed amendments to IFRS 37. This is because some obligations previously defined as contingent liabilities will now be regarded as liabilities or unrecognised liabilities, and will therefore qualify as liabilities to be considered for recognition in a business combination. In addition, in many cases, the obligation previously defined as a possible obligation, will now be analysed more precisely into two obligations: a contingent liability and a provision. The effect of recognising the provision at fair value under the amended IFRS 3 will be similar to recognising the contingent liability at fair value under the present version of IFRS 3, because the measurement of the provision accompanying the contingent liability will reflect the likelihood of the contingent liability becoming a present obligation and the amount and timing of any ensuing outflow of economic resources.

BC29. Nonetheless, the Board observed that not all contingent liabilities (as newly defined) are accompanied by present obligations. Therefore, in some cases, an obligation that might have been recognised under IFRS 3 will no longer qualify for recognition under the proposed amendments to IFRS 37. For example, the Board noted that an entity’s obligation to take back previously sold products for disposal that is conditional on the passing of a new law is a contingent liability and that there is no present obligation until the law is substantively enacted. Regardless of the probability of the law being enacted, the Board decided that no liability should be recognised as the entity does not have a present obligation (unless the entity by its own actions created a constructive obligation prior to enactment of the law).

Amendments required to IAS 37 as a result of amending the definition of a contingent liability

BC30. Having amended the definition and analysis of a contingent liability, the Board identified two aspects of IAS 37 that required reconsideration:

(a) the Standard’s recognition criteria; in particular

(b) the probability recognition criterion.

Recognition criteria

BC31. The recognition requirements of IAS 37 combine two steps: (i) a determination of whether an entity has a present obligation and, if so, (ii) an assessment of whether that present obligation should be recognised. As noted in
paragraph BC27 above, the Board’s revised analysis of contingent liabilities places greater emphasis on determining whether an obligation satisfies the definition of a liability in the Framework. The Board therefore decided that the structure of the Standard should emphasise that entities should first determine whether they have satisfied the definition of a provision and, if so, then determine whether that provision qualifies for recognition.

BC32. The Board decided to separate the requirements that relate to whether an item satisfies the definition of a liability (former paragraphs 15-26) from those that relate to whether that present obligation should be recognised (former paragraphs 23-26).

Probability recognition criterion

BC33. Paragraph 14(b) of IAS 37 specifies that a provision is recognised “if it is probable [more likely than not] that an outflow of resources embodying economic benefits will be required to settle the obligation.” The Board noted that in many cases, an entity does not need to make any assessment of probability 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 timing and the amount of the outflow. An example is an entity that has an obligation to decommission a nuclear power station.

BC34. However, the Board noted that in some other cases, the application of the probability recognition criterion in IAS 37 was more troublesome. For example, in the case of a guarantee, Example 9 to 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 Revenue the entity would recognise a gain. This accounting is counterintuitive, because an entity that has been paid to assume an obligation recognises a gain on initial recognition, followed by losses if payments are made.

BC35. The Board addressed the accounting for guarantees in its Exposure Draft Financial Guarantee Contracts and Credit Insurance. However, the Board noted that its analysis of contingent liabilities highlighted a more fundamental problem with the probability recognition criterion in IAS 37. In some cases, the criterion is applied to the contingent liability rather than the provision. For example, in the case of a guarantee, it is applied to the guarantor’s conditional obligation (contingent liability) to make a payment under the guarantee. Similarly in the example of a product warranty (Example 1), the criterion is applied to the entity’s conditional obligation to repair or replace the product.

BC36. The Board concluded that applying the probability recognition criterion to the contingent liability conflicted with the Framework. As noted in paragraph BC24, the liability that is being considered for recognition in the case of a guarantee or a product warranty is the present obligation to perform 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 Board decided that the probability recognition criterion should be applied to the present obligation.
BC37. The Board considered the meaning of a probable “outflow of resources embodying economic benefits”. It noted that in the example of a guarantee, IAS 37 suggests that it is the transfer of cash to the guaranteed party and in the case of the product warranty, it is the resources required to repair (or replace) the product, i.e. a transfer of assets. However, the Board noted that paragraph 62 of the Framework explains that the transfer of resources required to settle a present obligation can occur in ways other than by payment of cash or transfer of other assets. For example, the transfer of resources can be in the form of the “provision of services”. The Board reasoned that as an entity that issues a guarantee or a product warranty has an obligation to provide a service, 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.

BC38. The Board noted that regarding the outflow of resources as the provision of services means that an entity that issues a guarantee or a product warranty satisfies the probable outflow recognition criterion. The outflow of economic resources (the provision of services) is not only probable, it is certain. This is the case even if it is not probable that the entity will be required to make a payment under the guarantee or a claim will arise under the warranty. As noted above, the probability of a payment being required under a guarantee, or a claim arising under a product warranty, relates to the likelihood of the contingent liability (conditional obligation) becoming a present obligation. The Board agreed 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.

BC39. The Board’s conclusions about the application of the probability recognition criterion in the case of warranties and guarantees are consistent with FASB Interpretation 45 Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 explains that the 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. This is because the FASB concluded that a guarantor has “a noncontingent obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur”, and that the outflow of resources associated with this obligation is the requirement “to … stand ready to provide services” and not the possible payments required under the guarantee.

BC40. The Board noted that the notion of an obligation to stand ready in FIN 45 was derived from Concepts Statement 6. The Board concluded that it was the same as the notion in the Framework of an obligation to provide a service, because an entity that is standing ready is providing a service. The Board agreed that the expression stand ready was a helpful way of characterising the nature of the service obligation.

BC41. The Board observed that its conclusion about the application of the probability recognition criterion to a guarantee or product warranty could be extended to any provision accompanying a contingent liability and arising from a contract. This is because such provisions arise from the contractual obligation 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. (Using the terminology from FIN 45, 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. (Again, using the terminology from FIN 45, the retailer is standing ready to accept returns.)

BC42. The Board then considered provisions 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 some non-contractual obligations. For example, in the case of a lawsuit, the Board observed that although the damages that a defending entity might be required to pay are a contingent liability, the entity has no discretion other than to perform as directed by the court. The Board therefore concluded that the contingent liability was accompanied by a present obligation, namely an obligation to stand ready to pay any damages (or other 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 probability recognition criterion is satisfied and reflects that 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.

BC43. The Board observed that the above conclusions about the application of the probability recognition criterion meant that in practice the criterion would have little effect in determining whether a liability should be recognised, because in all cases the criterion would be satisfied. The Board therefore considered whether it should withdraw the probability recognition criterion from the Standard itself. The Board noted that the criterion might be misapplied in some examples; in particular that it might be applied to the entity’s contingent liability rather than 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 as a basis of determining whether they have incurred a provision, rather than using the definition of a liability. In particular, an entity that has a conditional obligation with a very high probability of resulting in an outflow of resources may conclude that it should recognise a provision. However, if the definition of a liability is not satisfied, no provision should be recognised. Lastly, the Board noted that it would add unnecessary complexity to the Standard to have a criterion that is in effect always satisfied. The Board therefore decided to withdraw the criterion.

BC44. The Board acknowledged that the criterion is derived from the Framework and therefore withdrawing the criterion from the Standard might give the impression of inconsistency with the Framework. Indeed, the Board was aware that many of its constituents consider some of its recent Standards to be 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 because the wrong obligation is being considered, ie the contingent (or conditional) obligation rather than the unconditional obligation. Having refined the analysis of certain liabilities in
IAS 37 in order 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 revised. However, the revised interpretation is consistent with the Framework. Furthermore, it results in consistent recognition of contractual obligations under 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 under 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.)

BC45. Finally, the Board considered the measurement of a provision accompanying a contingent liability. The Board noted that in some cases, the service obligation (stand ready obligation) might be separately priced, for example, in the case of some product warranties. However, in many cases the Board noted that there would be no directly observable market price, 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 expected to settle the service obligation (or stand ready obligation) would reflect the likelihood, amount and timing of the expected cash flows attaching to the conditional obligation. Therefore, while a contingent liability is itself not recognised, when it is accompanied by a provision that qualifies for recognition, the measurement of the provision reflects the likelihood of the contingent liability becoming a present obligation and the amount and timing of any ensuing outflow of economic resources.

Amendments arising from Short-term Convergence project

BC46. In September 2002 the Board agreed to add a Short-term Convergence project to its active agenda. The objective of the project is to reduce differences between IFRSs and US GAAP that are capable of resolution in a relatively short time and can be addressed outside of current and planned major projects. The project is a joint project with the FASB.

BC47. 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 highest 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.

BC48. As part of the review of topics recently considered by the FASB, the Board considered the requirements of Statement of Financial Accounting Standards No. 146 Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), which was issued in June 2002.

BC49. SFAS 146 nullifies EITF Issue No. 94-3 Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit and Activity (including Certain Costs Incurred in a Restructuring) (Issue 94-3). Since Issue 94-3 had 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 provisions for restructuring costs (a point explicitly 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 (former paragraphs 70-83) could result in the recognition of provisions that do not meet the definition of liabilities under the Framework.

BC50. The Board concluded that by converging with the recognition requirements of SFAS 146, the accounting for similar events and circumstances would be the same, thereby improving the comparability and representational faithfulness of reported 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) inserting an additional recognition criterion for some provisions for onerous contracts; and

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

Definition of constructive obligation

BC51. 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, that is to say, 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 give 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.

BC52. 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.

BC53. The Board observed that paragraph 40 of Concepts Statement 6 states that although constructive obligations “lack the legal sanction that characterized 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).

BC54. The Board considered the three essential characteristics of a liability identified by Concepts Statement 6 and referred to in the Basis for Conclusions on both SFAS 146 and SFAS 143 Accounting for Asset Retirement Obligations. The Board noted that like the definition of a constructive obligation in IAS 37, these 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”. However, the Board noted that for that promise to create an obligation others 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 the counterparty must be the recipient of the promise; the counterparty must reasonably expect the entity to perform; and the counterparty will either benefit from the entity’s performance or suffer loss or harm from non-performance.

BC55. 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 within the framework of the doctrine of ‘promissory estoppel’. Promissory estoppel is “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”.†

BC56. Having carefully considered the FASB’s deliberations, the Board concluded that the recognition threshold for a constructive obligation is higher under US GAAP than under IAS 37. This is because under US GAAP, the other parties must be able to rely on the entity’s carrying out its promise, whereas under 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 different emphases mean 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.

BC57. The Board considered whether it should introduce the notion of promissory estoppel into the definition of a constructive obligation. However, it noted that its Standards are intended to apply under many jurisdictions some of which may not have the notion of promissory estoppel. Nevertheless, the Board concluded that it could converge with US GAAP by introducing into the definition of a constructive obligation the notion that the counterparty should reasonably be able to rely on the entity’s discharging its responsibilities.

BC58. The Board observed that its proposed amendment should not alter existing practice for well-understood examples of constructive obligations (for example, certain 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.

**Recognition of provisions for onerous contracts**

BC59. The Board noted that in US GAAP there are no general requirements for onerous contracts similar to those contained in IAS 37. However, the Board noted that SFAS 146 provides specific accounting guidance for two classes of contract termination costs that under IFRS 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 the contract for its remaining term without economic benefit to the entity (for example, an operating

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* Paragraphs B25b and B19a of SFAS 143 and SFAS 146 respectively.

† This definition of promissory estoppel in SFAS 143 is from Black’s Law Dictionary.
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.

BC60. 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 present requirements in IAS 37 would be likely to result in entities recognising provisions for these onerous contracts on the basis of a commitment, or an intent, to restructure. This is because IAS 37 requires a provision for an onerous contract to be recognised when the contract is onerous, i.e. 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.

BC61. The Board noted that questions relating to the timing of recognition of an onerous contract provision 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 meets 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 in effect 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 an onerous contract provision is more akin to an impairment loss (i.e. of the unrecognised asset arising under the lease contract) than a provision.

BC62. However, 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 agenda (on revenue recognition and leasing) that could affect the present accounting for leases and executory contracts and therefore affect the requirements relating to onerous contracts. Nevertheless, it acknowledged that the present requirements might result in items being recognised as provisions on the basis of management commitment, 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 and outside a restructuring plan, the Board agreed 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.

BC63. The Board noted that onerous contracts broadly fall into two 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 falls below the prevailing market 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). The Board therefore agreed to adopt the recognition requirements of SFAS 146 by specifying that when a contract becomes onerous as a result of the entity’s own actions, the provision should not be recognised until the action has
occurred. The Board believes that until the entity has actually undertaken the action that makes the contract onerous (for example, exercised its option to terminate the contract or ceased using the leased asset), the entity has the discretion to change its intended action.

**Sublease income**

BC64. 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 agreed that it should provide the same specific guidance on this point in IAS 37 because it was informed that in practice there is uncertainty surrounding the recognition of sublease income.

BC65. 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 if it specified that the sublease rentals should be those that the entity expects to achieve, significant changes in the provision might be reported as the entity revises its decision to sublease or not. Furthermore, the Board believes that taking account of the sublease rentals that the entity could reasonably obtain for the property is consistent with the present notion in IAS 37 of the “unavoidable costs under a contract”.

**Restructuring provisions**

BC66. 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 disposal 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 an obligating event by imposing a constructive obligation on the entity. It noted the guidance in paragraph 17 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, it is not bound by its plan to the extent that it cannot avoid an outflow of resources. The Board therefore decided that because an entity can recall its restructuring plan once it has been announced, the restructuring guidance is a misapplication of the Standard’s notion of a constructive obligation.

BC67. The Board therefore agreed to withdraw the present guidance for the recognition of restructuring provisions in IAS 37 and state that liabilities arising from a restructuring should be recognised in the same way as those that arise outside a restructuring, namely when the entity incurs a present obligation, the settlement of which will probably result in an outflow of economic benefits that can be measured reliably.

BC68. The Board also agreed that it should follow the example of SFAS 146 and provide specific guidance for applying its recognition requirements to costs that are often associated with a restructuring:

(a) termination benefits;
(b) costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity; and

(c) costs to terminate a contract before the end of its term.

Termination benefits

BC69. 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 these 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).

Costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity and costs to terminate contracts

BC70. The Board noted that costs arising in a restructuring that (a) will continue to be incurred under a contract for its remaining term without economic benefit to the entity or (b) will be incurred as a result of terminating contracts would be examples of onerous contracts. The Board therefore concluded that it need only specify that the contracts are onerous contracts and provide a cross-reference to paragraphs X-X of the draft Standard that specify the requirements for onerous contracts. The Board believes that, as noted above, having amended the requirements for onerous contracts, it has largely achieved convergence with US GAAP on the accounting for these costs.

Provision for the sale of an operation

BC71. In amending the present guidance for the recognition of restructuring provisions, the Board has 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, that is a matter for recognising an impairment loss either under IAS 36 Impairment of Assets or under IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

Other amendments

Measurement

BC72. The Board observed that the FASB has adopted a fair value measurement objective in some of its recent Statements (including SFAS 146), because the FASB believes this to be 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 at the balance sheet date”.

BC73. The IAS 37 requirement can be interpreted as similar to fair value, but the Board acknowledges that the phrase leaves certain 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 measurement. Nonetheless, the Board was concerned that the Standard’s present measurement requirements were not always consistent and could be interpreted in different ways. The Board therefore proposes some
improvements to this part of the Standard. The Board emphasises that these amendments do not change the cash flows that should be used in estimating provisions and contingent liabilities; however, they do require changes in the way those cash flows should be used in estimating provisions.

**Rationally pay to settle or transfer**

BC74. 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 provisions and is less likely to be misinterpreted than the notion of “best estimate”.

**Use of expected value estimation technique**

BC75. The Board noted IAS 37 does not prohibit single obligations being measured at “the individual most likely outcome”. For example, 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 Board noted that the Standard could be interpreted to requiring the provision to be measured at CU1 million. The Board, however, observed that measuring a provision at the “individual most likely outcome” conflicts with the principle of measuring provisions, 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 would be a chance of settlement at no cost, it would not settle the obligation for the maximum amount that might be required. Rather, it would take into consideration the expected value of the potential outcomes. The Board therefore decided to emphasise that expected value, which is currently cited as an estimation method that can be used for measuring provisions for a large population of items, is also appropriate for single obligations.

**Discount rate**

BC76. The Board noted that in practice there is some confusion about whether the Standard requires a current discount rate to be used both on initial recognition of a provision and subsequent measurement. The Board therefore agreed to clarify that when discounting is used, the rate should be the current rate at each balance sheet date. The Board acknowledges that in relation to subsequent measurement of a provision this is different from both SFAS 143 and SFAS 146; however, the Board believes that the use of a current rate is more representationally faithful and consistent with the existing requirements of IAS 37.

**Reimbursements**

BC77. 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.

BC78. The Board observed that most reimbursements arise from insurance contracts, indemnity clauses or supplier’s warranties. The Board therefore observed that in such examples an entity has a contingent asset (conditional right) and an unconditional right that satisfies the definition of an asset. That is to say, the reimbursement itself is a contingent asset, but the insurance contract, indemnity clauses or supplier’s warranty establish 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 reimbursement to explain that the reimbursement asset that an entity should recognise is the *right* to reimbursement, and not the reimbursement, as this is the unconditional right that the entity controls.

BC79. The Board agreed that the right to reimbursement should be recognised following the recognition criteria in the *Framework*, i.e. 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 criterion should be applied to the asset (unconditional right) and not the reimbursement (contingent asset). This means that if an entity has a *right* to reimbursement, the probability criterion would generally be satisfied, because the economic benefits embodied in the unconditional right are a certainty—there is no question that the entity has a right to look to another entity for reimbursement. Because of this, and to ensure that entities do not apply the probability criterion to the contingent asset, the Board concluded that it should specify only reliable measurement as a recognition criterion. The Board’s view is that if the entity has recognised a provision and has an unconditional right to reimbursement, that right to reimbursement warrants recognition as an asset.
Appendix A

Tables—Provisions, Contingent Liabilities, Contingent Assets and Reimbursements

The purpose of this appendix is to summarise the main requirements of the Standard. It does not form part of the Standard and should be read in the context of the full text of the Standard.

Provisions and Contingent Liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

<table>
<thead>
<tr>
<th>There is a present obligation that probably requires an outflow of resources.</th>
<th>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.</th>
<th>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A provision is recognised (paragraph 14).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disclosures are required for the provision (paragraphs 84 and 85).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No provision is recognised (paragraph 27).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disclosures are required for the contingent liability (paragraph 86).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No provision is recognised (paragraph 27).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No disclosure is required (paragraph 86).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability.
**Contingent Assets**

Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

<table>
<thead>
<tr>
<th>The inflow of economic benefits is virtually certain.</th>
<th>The inflow of economic benefits is probable, but not virtually certain.</th>
<th>The inflow is not probable.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The asset is not contingent (paragraph 33).</td>
<td>No asset is recognised (paragraph 31).</td>
<td>No asset is recognised (paragraph 31).</td>
</tr>
<tr>
<td>Disclosures are required (paragraph 89).</td>
<td>No disclosure is required (paragraph 89).</td>
<td>No disclosure is required (paragraph 89).</td>
</tr>
</tbody>
</table>
Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.

<table>
<thead>
<tr>
<th>The entity has no obligation for the part of the expenditure to be reimbursed by the other party.</th>
<th>The obligation for the amount expected to be reimbursed remains with the entity and it is virtually certain that reimbursement will be received if the entity settles the provision.</th>
<th>The obligation for the amount expected to be reimbursed remains with the entity and the reimbursement is not virtually certain if the entity settles the provision.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The entity has no liability for the amount to be reimbursed (paragraph 57).</td>
<td>The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the income statement. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 53 and 54).</td>
<td>The expected reimbursement is not recognised as an asset (paragraph 53).</td>
</tr>
<tr>
<td>No disclosure is required.</td>
<td>The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 85(c)).</td>
<td>The expected reimbursement is disclosed (paragraph 85(e)).</td>
</tr>
</tbody>
</table>
Appendix B

Decision Tree

The purpose of the decision tree is to summarise the main recognition requirements of the Standard for provisions and contingent liabilities. The decision tree does not form part of the Standard and should be read in the context of the full text of the Standard.

Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (paragraph 15 of the Standard).
Appendix C  Illustrative Examples

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

Contents

Recognition examples
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Example 2 A Disputed Lawsuit
Example 3 An Extended Warranty
Example 4 A Single Guarantee
Example 5 Joint and Several Liability
Example 6A Contaminated Land – Legislation Expected to be Enacted
Example 6B Contaminated Land and Constructive Obligation
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Example 9 Closure of Division
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Example 11 Legal Requirement to Install Smoke Filters
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Example 13 Repairs and Maintenance
Example 14 Self-Insurance

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Example 16 Disclosure of Decommissioning Obligation
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Examples: Recognition

This appendix illustrates the application of the Standard to assist in clarifying its meaning. It does not form part of the Standard.

All the entities in the examples have 31 December year-ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the examples.

The cross-references provided in the examples indicate paragraphs of the [draft] Standard that are particularly relevant. The appendix should be read in the context of the full text of the Standard.

References to ‘best estimate’ are to the present value amount, where the effect of the time value of money is material.

Example 1: A Potential Lawsuit

Shortly before 31 December 20X0, a patient dies in hospital as a result of a mistake made during an operation. The hospital’s past experience and lawyers’ advice indicate that in these circumstances it is highly likely that the patient’s relatives will commence legal proceedings and, if the matter comes to court, that the hospital will be found guilty of negligence. The hospital’s policy is therefore to attempt to resolve any disputes out of court.

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. The hospital had a legal obligation to perform the operation with due care.

Conclusion - A provision is recognised. (The measurement of the provision reflects the amount and timing of the cash flows required to settle the case.)

Example 10 2: A Disputed Lawsuit Court Case

After a wedding in 2000 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 but it disputes liability. Up to the date of authorisation for issue of the financial statements for the year to 31 December 20X0, legal proceedings for issue, the entity’s lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 December 2001, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable.

(a) At 31 December 2000

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events. The past event is the sale of the food because the entity has a legal obligation not to provide harmful food.
**Conclusion** - No A provision is recognised (see paragraphs 15-16). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 36). (The measurement of the provision reflects the likelihood that the entity will be found liable and the amount and timing of the cash flows required to settle the case.)

(b) At 31 December 2001

Present obligation as a result of a past obligating event — On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement — Probable.

Conclusion — A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-16).

**Example 4.3: Warranties An Extended Product Warranty**

A manufacturer gives extended product warranties at the time of sale to purchasers of its product. Under the terms of the warranty contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating past event is the sale of the product with a warranty, which gives rise to a present legal obligation to provide a service for the duration of the warranty.

An outflow of resources embodying economic benefits in settlement — Probable for the warranties as a whole (see paragraph 24).

Conclusion — A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 24). (The measurement of the provision reflects the likelihood of products sold before the balance sheet date developing faults and the amount and timing of the cash flows required to repair or replace the products.)

Note: When an entity issues product warranties in exchange for a fee, revenue is recognised under IAS 18 Revenue.

**Example 9.4: A Single Guarantee**

On 31 December 1999 20X0, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 2000 20X1, the financial condition of Entity B deteriorates and at 30 June 2000 20X1 Entity B files for protection from its creditors.

This contract meets the definition of an insurance contract in IFRS 4. 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.

(a) At 31 December 1999

Present obligation as a result of a past obligating event - The obligating past event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 December 1999.

Conclusion - 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 under IAS 39 less, when appropriate, cumulative amortisation in accordance with IAS 18 Revenue.

(b) At 31 December 2000

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 December 2000, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - The guarantee is subsequently measured at the higher of (a) the best estimate of the obligation (see paragraphs 14 and 23), and (b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with IAS 18 Revenue.

Note: Where an entity gives guarantees in exchange for a fee, revenue is recognised under IAS 18 Revenue.

Example 5: 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 such that there is more than a remote possibility that Entity B may cease to be a going concern and 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 legal obligation for Entity A 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 – A provision is recognised. (The measurement of the provision reflects the likelihood of Entity A, rather than Entity B, being required to restore the land. Therefore, the provision may not initially warrant recognition on the basis of materiality. When Entity A recognises a provision, 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 2A 6A: Contaminated Land - Legislation Virtually Certain to be 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 has 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 clean-up of contamination, including prior contamination. At By 31 December 2000 20X0, the new law is substantively enacted it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end.

Present obligation as a result of a past obligating event - The obligating past event is the contamination of the land because of the virtual certainty of that is covered by substantively enacted legislation requiring cleaning up. The entity therefore has a legal obligation to clean up its contamination.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up obligation (see paragraphs 14 and 22).

Example 2B 6B: Contaminated Land and Constructive Obligation

An entity in the oil industry causes contamination and operates in a country where 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 obligating event - The obligating past event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that they can reasonably rely on the entity will to clean up contamination.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion - A provision is recognised for the best estimate of the costs of clean-up obligation (see paragraphs 10 (the definition of a constructive obligation), 14 and 17).

Example 3 7: Offshore Oilfield

An entity operates an offshore oilfield where its licensing agreement requires it 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 obligating event - The construction of the oil rig creates a legal obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of entity’s obligation to remove the oil rig and restore the damage caused by building it (see paragraph 14). These costs of the obligation are included as part of the cost of the oil rig. (The initial measurement of the provision 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 The 10 per cent of costs that arises through the extraction of oil are recognised as it is incurred, a liability ie when the oil is extracted).

Example 4.8: 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 obligating event - The obligating past event is the sale of the product, which gives rise to a constructive obligation to provide a service to customers who have purchased goods, because the conduct of the store has created a valid expectation on the part of its customers that they can reasonably rely on the store will to refund purchases.

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund (see paragraph 24).

Conclusion - A provision is recognised for the best estimate of the costs of refund (see paragraphs 10 (the definition of a constructive obligation), 14, 17 and 24) entity’s obligation to provide a service to its customers. (The measurement of this obligation 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.)

Example 5A.9: Closure of a Division - No Implementation Before Balance Sheet Date

On 12 December 2000 the board of an entity decided to close down a division. Before the balance sheet date (31 December 2000) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

Present obligation as a result of a past obligating event - There has been no obligating event and so there is no obligation.

Conclusion – No provision is recognised (see paragraphs 14 and 72).
Example 5B: Closure of a Division—Communication/Implementation Before Balance Sheet Date

On 12 December 2000, the board of an entity decided to close down a division making a particular product. On 20 December 2000 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

Present obligation as a result of a past obligating event—The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

Conclusion — A provision is recognised at 31 December 2000 for the best estimate of the costs of closing the division (see paragraphs 14 and 72).

On 12 December 20X0 the management of an entity approved a detailed plan for closing down a division. The plan requires (i) the termination of various contracts and (ii) closure of a factory that is leased under an operating lease that has four years of its term remaining. In addition, the plan requires the employment of the division’s employees to be terminated. On 31 December 20X0 the entity issued a press release stating its intention to close the division.

Prior to the entity’s division to close down the division, none of the contracts were considered onerous.

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

(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 an obligation to restructure.

Conclusion — No provision is recognised.

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

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

Conclusion — A provision is recognised at 31 January 20X1 for the contract termination costs.

(c) At the balance sheet date of 31 March 20X1

Present obligation as a result of a past event - The past event that makes the lease of the factory onerous is vacating the factory.

Conclusion — A provision is recognised at 31 March 20X1 for the unavoidable lease payments reduced by estimated sublease rentals that could reasonably be obtained for the factory. (The entity also continues to recognise a provision for the contract termination costs if those costs have not been settled by 31 March 20X1.)
The entity recognises termination benefits in accordance with the requirements of IAS 19 Employee Benefits.

Example 8 10: An Onerous Contract

An entity operates profitably from a factory that it has leased under an operating lease. During December 2000 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 and the factory cannot be re-let to another user. Since the entity entered into the lease, lease rates on commercial buildings in the entity’s location have fallen.

Present obligation as a result of a past obligating event - The obligating event is the signing of the lease contract for the old factory, which gives rise to a legal obligation. The contract is onerous because the entity does not expect to receive economic benefits from the factory but 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 an onerous contract is the entity vacating the old factory.

An outflow of resources embodying economic benefits in settlement - When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the entity accounts for the lease under IAS 17 Leases).

Conclusion - A provision is recognised. (Measurement of the provision is by reference to the best estimate of the unavoidable lease payments reduced by the estimated sublease rentals that the entity could reasonably obtain) (see paragraphs 5(c), 14 and 66).

Example 6 11: Legal Requirement to Fit Smoke Filters

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 2000 20X1. At 31 December 20X0 the entity has not fitted the smoke filters but has continued to operate the factories.

(a) At the balance sheet date of 31 December 1999 20X0

Present obligation as a result of a past obligating event - There is no present obligation because there is no obligating past event either for the costs of fitting installing smoke filters or for fines under the legislation. This is because (a) the entity has the discretion to avoid installing the smoke filters and (b) at 30 December 20X0 the entity is in compliance with the legislation.

Conclusion - No provision is recognised for the cost of fitting installing the smoke filters (see paragraphs 14 and 17-19).

(b) At the balance sheet date of 31 December 2000 20X1

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting installing smoke filters because no obligating past event committing the entity to installing the filters has occurred (the fitting of 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 any fines or
penalties imposed under the legislation because the obligating event has occurred (the for non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting installing smoke filters. However, a provision is recognised for the obligation to pay best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 17-19).

Example 7 12: 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 in order 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 obligating event - There is no obligation because no obligating past event (retraining) has taken place. This is because the entity has the discretion to avoid retaining its workforce.

Conclusion - No provision is recognised (see paragraphs 14 and 17-19).

Example 11 13: Repairs and Maintenance

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. IAS 16 Property, Plant and Equipment gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

Example 11A 13A: 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 obligating event - There is no present obligation.

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company’s decision to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, ie it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Conclusion - No provision is recognised (see paragraphs 14 and 17-19).

Example 11B 13B: Refurbishment Costs - Legislative Requirement
An airline is required by law to overhaul its aircraft once every three years.

**Present obligation as a result of a past obligating event** - There is no present obligation.

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in example 11A. 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 - the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision 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 provision is recognised (see paragraphs 14 and 17–19).

**Example 14: 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 cover and decides to ‘self insure’, that is 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 provision is recognised.
Appendix D

Example: Disclosures

The appendix is illustrative only and does not form part of the [draft] Standard. The purpose of the appendix is to illustrate the application of the [draft] Standard to assist in clarifying its meaning.

Two examples of the disclosures required by paragraph 85 are provided below.

Example 15: Disclosure of Warranties 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 provision of CU60,000 has been recognised. The provision has not been discounted as the effect of discounting is not material. The following information is disclosed:

A provision of CU60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure claims will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.
Example 2 16: Disclosure of Decommissioning Costs Obligation

In 2000, an entity involved in nuclear activities power generation recognises a provision for decommissioning costs of £300 million. The provision is based on the estimated decommissioning costs that are expected to be incurred 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’ time and a - However, there is a possibility 10 per cent likelihood that it will not take place until 100-110 years’ time, in which case the present value of the costs will be significantly reduced. The following information is disclosed:

A provision of £300 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 provision. If the costs were measured based upon the expectation that they would not be incurred until 2100-2110 the provision would be reduced to £136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2 per cent.

An example is given below of the disclosures required by paragraph 92 where some of the information required is not given because it can be expected to prejudice seriously the position of the entity.

Example 3 17: 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 £100 million. The entity recognises a provision for its best estimate of the amount that it would rationally pay to settle or transfer the obligation, but discloses none of the information required by paragraphs 84-81 and 85-82 of the Standard because this information can be expected to prejudice seriously the position of the entity. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of £100 million. The information usually required by IAS 37 Provisions, Contingent Liabilities and Contingent Assets, is not disclosed on the grounds that 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.
PROPOSED AMENDMENTS TO

IAS 19
EMPLOYEE BENEFITS

[notes: For the purpose of this Exposure Draft, the new text is underlined and the deleted text is struck through. [The text incorporates all proposed amendments from insert details of any EDs outstanding at time of publication]]
**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, where 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 redundancy are termination benefits only if they are offered for a short period of time (see paragraph 7). Other employee benefits that are offered to encourage employees to leave service should therefore be treated as post employment benefits.

Do you agree with this amendment? If not, why not?

**Question 2 – Recognition of termination benefits**

The Exposure Draft proposes that, with the exception of involuntary termination benefits that are provided in exchange for employees’ future services, a liability for termination benefits should be recognised when the entity has a present obligation to provide the benefits. For involuntary termination benefits this is when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria (see paragraph 139). For voluntary termination benefits, this is when employees accept the entity’s offer of voluntary redundancy (see paragraph 140).

Is recognition of a liability for involuntary and voluntary 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 when 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 paragraphs 141). The Exposure Draft proposes three criteria for determining whether involuntary termination benefits are provided in exchange for future services (see paragraph 142).

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

**Question 4 – Measurement of termination benefits**

The Exposure Draft proposes that the liability for termination benefits should be measured at fair value (see paragraph 145).

Is measurement at fair value appropriate? If not why not?
Summary of Main Changes (IAS 19)

The following main changes are proposed:

Termination benefits
Contents

International Accounting Standard IAS 19
Employee Benefits

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... EFFECTIVE DATE 159C
Limited Amendments to
International Accounting Standard 19
Employee Benefits

[Marked-up text]

Definitions
[Amend paragraph 7]
7. The following terms are used in this Standard with the meanings specified:

... 

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

(a) involuntary termination 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, offered only for a short period of time in exchange for an employee’s decision to accept voluntary redundancy 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
[Amend paragraphs 132-143]
132. This Standard deals with termination benefits separately from other employee benefits because, except as described in paragraphs 141-143, the event which gives rise to an obligation is the termination rather than employee service.

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 under the terms of an established benefit arrangement. For example, they may be specified by statute, employment contract or union agreement, or implied as a result of the employer’s past practice of providing similar benefits. In some cases, however, there is no obligation to provide involuntary termination benefits and they are provided at the discretion of the entity.

135. Some entities offer benefits to encourage employees to leave service. For the purpose of this [draft] Standard, only such benefits that are offered for a short period of time are treated as termination benefits. Benefits that are not offered for a short period of time are treated as a post-employment benefit under this [draft] Standard, because the benefits are payable in exchange for the employees’ service.

136. Some employee benefits are payable 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 under this [draft] Standard. Some entities provide a lower level of benefit for voluntary termination 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 is a termination benefit.

137. Termination benefits do not provide an entity with future economic benefits and are recognised as an expense immediately.

138. Where an entity recognises termination benefits, the entity may also have to account for a curtailment of retirement benefits or other employee benefits (see paragraph 109).

Recognition

138. An entity shall recognise termination benefits as a liability and an expense when, and only when, the entity is demonstrably committed to either:

(a) terminate the employment of an employee or group of employees before the normal retirement date; or

(b) provide termination benefits as a result of an offer made in order to encourage voluntary redundancy.

134. An entity is demonstrably committed to a termination when, and only when, the entity has a detailed formal plan for the termination and is without realistic possibility of withdrawal. The detailed plan shall include, as a minimum:

(a) the location, function, and approximate number of employees whose services are to be terminated;

(b) the termination benefits for each job classification or function; and

(c) the time at which the plan will be implemented. Implementation shall begin as soon as practicable and the period of time to complete
implementation shall be such that material changes to the plan are not likely.

139. An entity has a present obligation to provide 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 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 (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.

140. An entity has a present obligation to provide voluntary termination benefits when the employees accept an entity’s offer of voluntary redundancy.

141. When 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.

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

(a) are not provided under the terms of an established benefit arrangement;

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

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

143. When involuntary termination benefits are provided in exchange for employees’ future services, the liability for the termination benefits measured as at the termination date shall be recognised on a straight-line basis over the period from (i) the date the entity communicates its termination plan to the affected employees and the plan meets the criteria in paragraph 139 to (ii) the date that employment is terminated.

144. In some cases, employees provide involuntary termination benefits that are expressed in terms of an enhancement of an established benefit arrangement (for example, a doubling of statutory benefits or an increase in early retirement benefits paid under a pension plan). If the termination benefits that are attributable to the enhancement of the established benefit arrangement are provided in exchange for employees’ future services and satisfy the criteria in paragraph 142, they shall be recognised in accordance with paragraph 141.

Measurement

139. Where termination benefits fall due more than 12 months after the balance sheet date, they shall be discounted using the discount rate specified in paragraph 78.
140. In the case of an offer made to encourage voluntary redundancy, the measurement of termination benefits shall be based on the number of employees expected to accept the offer.

145. An entity shall measure the liability for termination benefits at its fair value.

146. When, in accordance with paragraph 140, the liability for termination benefits is recognised over future service periods, the effect of changes to the liability shall be recognised in the period of change.
Example illustrating paragraphs 138-146

Background

As a result of a recent acquisition, an entity plans to shut down a manufacturing facility in 16 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 a number of contracts, it announces a termination benefit plan as follows. Each employee who stays and renders service for the full 16-month period will receive as a termination benefit on the termination date a cash payment of three times the amount specified by employment legislation. An employee who leaves voluntarily before the facility is shut down will not be entitled to receive any portion of the termination benefit.

The entity’s usual practice is to provide the minimum termination benefits specified by employment legislation. Under the terms of the employment legislation, the entity is required to provide 60 days’ notice of its intention to terminate employment.

The total expected cash flows under the termination benefit plan are CU3 million.* These take into account the likelihood that some employees will leave voluntarily before the facility is shut down.

In accordance with paragraph 144, the entity accounts for the established benefit and the enhancement separately.

Established benefit

A liability for the established termination benefits of CU902,475 is recognised when the termination benefit plan is announced. This represents the expected cash flows of CU1 million that the entity is required to pay under the legislation, discounted for 16 months at the credit-adjusted risk-free rate of 8 per cent.

The liability is adjusted each month to reflect the passage of time, changes in the discount rate and changes in the assumptions about how many employees will leave voluntarily.

Enhancement

The liability for the enhanced termination benefits (which relate to future services) measured as at the termination date is CU2 million. Because the liability is measured as at the termination date, it is not discounted. A liability and expense of CU125,000 is recognised in each month during the future service period of 16 months.

After eight months, more employees than originally estimated leave voluntarily before the facility is shut down, and hence are not entitled to termination benefits. The entity now estimates that the total cash flows under the termination benefit plan will be CU2,400,000, of which CU1,600,000 relates to service after the announcement date. Based on that revised estimate, an expense of CU100,000 would have been recognised in each month during the future service period.

Thus, the liability recognised to date of CU1,000,000 (CU125,000 × 8) is reduced to CU800,000 (CU100,000 × 8) to reflect the change. A liability and expense of

* In this example, monetary amounts are denominated in ‘currency units’ (CU).
CU100,000 is recognised in each month during the remaining future service period of eight months.

Disclosure

141. Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists. As required by IAS 37 Provisions, Contingent Liabilities and Contingent Assets, an entity discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

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

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

Effective Date

[Paragraph 159C is added]

159C. An entity shall apply the amendments in [draft] paragraphs 132-148 for annual periods beginning on or after 1 Month 200X. Earlier application is encouraged. If an entity applies these amendments for a period beginning before 1 Month 200X, it shall disclose that fact.
Basis for Conclusions

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

Introduction

BC1. This Basis for Conclusions summarises the 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 are as a result of the Board’s Short-term Convergence project.

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

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 highest 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 Statement of Financial Accounting Standards No. 146 Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), which was issued in June 2002. SFAS 146 provides specific guidance for accounting for costs typically incurred in an exit or disposal activity. These costs include a class of termination benefits known as ‘one-time termination benefits’, which 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.”

BC7. SFAS 146 does not alter the accounting for other termination benefits specified by earlier FASB Statements (principally SFAS 88 Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (SFAS 88) and SFAS 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 agreed that in general it should not seek convergence with these earlier Statements.
Nonetheless, the Board concluded that it could improve the accounting for termination benefits and increase convergence with US GAAP by converging with the principles of SFAS 146 relating to one-time termination benefits and applying those principles consistently to all 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 which gives rise to a present obligation for termination benefits is the termination of employment rather than employee service. A liability for termination benefits is therefore recognised when the entity is demonstrably committed to the termination. In contrast, under SFAS 146 certain one-time termination benefits are regarded as provided in exchange for employees’ future services. In such cases, the liability is recognised over the period that the employees render service, consistently with the accounting for other employee benefits.

BC9 The Board agreed with the FASB that in some cases termination benefits are provided in exchange for employees’ future services. For example, the Board observed that, following an acquisition, entities sometimes terminate the employment of the acquired employees. 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. The Board therefore decided that, like SFAS 146, IAS 19 should specify different recognition requirements for termination benefits that are provided in exchange for future service.

BC10 Under 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 the 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 relate to past service rather than future service.

BC11 Like the FASB, the Board agreed 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 relate to all involuntary termination benefits, and not just one-time termination benefits, the Board decided that it would need to specify a third criterion, namely that the benefits are not paid under the terms of an established benefit arrangement (whether that be an employment contract, union agreement, legal
requirement, or implied by the entity’s usual custom). The Board reasoned that if the termination benefits are paid under the terms of an established benefit arrangement, those benefits would not be provided in exchange for future services because the entity would be obliged to provide them. The Board noted that in these cases the employees would know the benefits to which they would be entitled in the event of their employment being terminated and 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.”

BC13. The Board also noted that in some cases, an employer might offer termination benefits in excess of those specified by the pre-existing benefit arrangement (for example, a doubling of statutory benefits). The Board concluded that although the enhancement might be expressed in terms of an established benefit arrangement, the enhancement should be treated as a separate benefit arrangement. Therefore, if the enhancement is provided in exchange for employees’ future services (because it meets the criteria in paragraph 142) it is recognised over future service periods, even though the wording of the enhancement determines the benefit with reference to past service.

BC14. The Board adopted the notion from SFAS 146 of a minimum retention period because, like the FASB, it acknowledged that an entity may need to notify employees of the termination of employment in advance of the termination as a result of a legal, contractual or union requirement. The Board, however, decided to broaden the definition to also include notice periods that are implied by the entity’s past practice.

Recognition of involuntary termination benefits

BC15. The Board then considered the recognition under SFAS 146 of 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. Under SFAS 146, the liability for such benefits is recognised when the entity has a plan of termination that (i) meets specified criteria and (ii) the plan 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 present criteria in IAS 19 for establishing whether an entity is committed to a termination 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 could 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 under the terms of an established benefit arrangement, 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. The Board therefore 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 existing or one-time benefit arrangement) 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. Under US GAAP, most voluntary termination benefits are accounted for under SFAS 88 rather than 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 to IAS 19, because IAS 19 specifies that the benefits are recognised when the entity is demonstrably committed to a termination. The Board concluded, however, that the requirement of SFAS 88 is closer to the principle underlying SFAS 146 (namely, that a liability is recognised when incurred), because until an employee accepts an entity’s offer of voluntary redundancy there is no mutual understanding of the benefit arrangement. The Board also noted that until an employee accepts the offer of voluntary redundancy, the entity has the discretion to withdraw the offer. The Board therefore 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 only for a short period of time. The Board agreed 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 of time, employees would treat the benefits as part of their employment package. The benefits would therefore be payable in exchange for the employees services and therefore should be treated as for any other post-employment benefit. The Board therefore decided to amend the definition of termination benefits to clarify that for benefits paid to encourage employees to leave service to be regarded as voluntary termination benefits under this Standard, those benefits must be made available only for a short period.

Measurement

BC20. The Board proposes that the liability for termination benefits should be measured at fair value, consistently with the measurement objective of SFAS 146.
BC21. The Board noted that there is no equivalent in IFRSs of Concepts Statement No. 7 Using Cash Flow Information and Present Value in Accounting Measurements (Concepts Statement 7), which establishes fair value as a measurement objective. The Board also concluded that, in general, seeking convergence with SFAS 146’s measurement objective was outside the scope of the Short-term Convergence project. However, the Board observed that, in those cases where termination benefits do not vest immediately, the measurement of the liability should reflect the likelihood that some employees will leave voluntarily before the benefits vest. The Board concluded that this was best conveyed by specifying a fair value measurement objective for termination benefits.

BC22. When the liability for the termination benefits is incurred over time, the Board agreed with the FASB that for practical purposes the liability for termination benefits should be measured at the date the benefits are communicated and based on the fair value of the liability as of the termination date. The Board also agreed with the FASB that when changes to either the timing or amount of the estimated cash flows occur, the effect of changes to liability as of the termination date should be reflected in the period of change.

BC23. The Board noted that the FASB decided to measure subsequent changes in the amount and timing of the cash flows using the interest rate used to measure the liability initially. Although the FASB noted that conceptually the liabilities should subsequently be measured at fair value, it argued that “until issues related to determining the fair values of financial instruments are resolved and fair value is required for subsequent measurement of more (or all) liabilities, it would be premature to require that type of ongoing measurement.” The Board, however, noted that this approach to subsequent measurement is inconsistent with the measurement requirements of IAS 37 that require the use of a current interest rate. Accordingly, it decided not to converge with US GAAP on this matter, but to require the liability to be remeasured using current interest rates. Nevertheless, given the relatively short periods over which termination benefits will be discounted, the Board does not believe that the difference between its proposals and SFAS 146 will have a significant impact in practice.