STAFF PAPER

~~June~~ July 2015

IASB Education Session

Project	**Research—provisions, contingent liabilities and contingent assets (IAS 37)**
Paper topic	**Implications of *Conceptual Framework* proposals**

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Summary

The IASB has published an Exposure Draft of a revised *Conceptual Framework*.[1]

The *Conceptual Framework* is not a Standard and does not override specific Standards. Furthermore, the IASB will not automatically change existing Standards as a result of changes to the *Conceptual Framework*. If an existing Standard works well in practice, the IASB will not propose an amendment to that Standard simply because of an inconsistency with the revised *Conceptual Framework*.

However, if the IASB were to take on a project to amend aspects of a particular Standard, it would be guided by the revised *Conceptual Framework*. It is possible that the concepts proposed in the *Conceptual Framework* Exposure Draft could help the IASB to address some of the matters discussed in Agenda Paper 14B *Possible Problems with IAS 37*.

In this paper, I have considered ways in which the concepts proposed in the *Conceptual Framework* Exposure Draft might guide the IASB's decisions if those concepts are finalised and if the IASB takes on a project to amend aspects of IAS 37.

[1] Exposure Draft *Conceptual Framework for Financial Reporting*, May 2015.

My tentative conclusions are that:

(a) the proposed concepts might lead the IASB to conclusions quite different from those it reached during its **previous project** to amend IAS 37.

(b) the proposed concepts could be the basis of clearer general guidance on **identifying liabilities**. The guidance would reconcile, and could replace, seemingly contradictory statements in IAS 37. Application of the guidance:

   (i) could lead to requirements for **levies** that are different from those in IFRIC 21 *Levies*, an interpretation of IAS 37. Liabilities for some levies would be recognised incrementally over the period of the activity that causes the amount potentially payable to increase, not at the possibly later point in time when a final activity triggers the requirement to pay the levy.

   (ii) could lead to requirements for **restructuring costs** that are expressed differently from those in IAS 37. There might be a different process for identifying liabilities, but possibly not major differences in the timing of recognition of many restructuring costs.

   (iii) would not necessarily change the time at which other liabilities are identified. (For example, there might be no change to the requirements for the specific type of waste disposal obligation addressed by IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*.)

(c) the proposed concepts could support the existing **recognition criteria** in IAS 37. The 'probable outflows' threshold in IAS 37 has been criticised because it is not applied in some other Standards and its effect is that some liabilities, although disclosed in the notes to the financial statements, are excluded from the statements of financial position and financial performance. The *Conceptual Framework* Exposure Draft proposes that recognition requirements may need to vary between Standards, and that in some cases the costs of recognition may outweigh the benefits. Liabilities within the scope of IAS 37 have characteristics that distinguish them from many other liabilities. In particular, they typically cannot be measured by reference to an observable transaction price—either current or historical. These characteristics might provide a basis for retaining the 'probable outflows' recognition threshold in IAS 37.

(d) the proposed concepts could help the IASB if it decided to develop more specific **measurement** requirements for liabilities within the scope of IAS 37. In particular:

(i) the *Conceptual Framework* Exposure Draft proposes that in selecting a measurement basis for an asset or a liability, it is important to consider how that asset or liability contributes to future cash flows. Entities tend to settle most liabilities within the scope of IAS 37 by fulfilling the liabilities themselves. The predominance of fulfilment as the method of settlement could lead the IASB to focus on 'fulfilment value' when developing measurement requirements for IAS 37.

(ii) the proposed concepts suggest that if the IASB were to specify a form of 'fulfilment value' measurement basis in IAS 37, it should consider whether, and if so how, to customise that basis to provide the most useful information about the liability and expenses, and to take into account the cost constraint. Previous stakeholder feedback suggests that if the IASB were to take this approach, it might consider:

- permitting or requiring entities to measure some liabilities by reference to the most likely outcome (with disclosure of information about other possible outcomes) instead the expected value (probability-weighted average) of all possible outcomes;
- excluding the effects of non-performance risk, and possibly excluding any risk adjustment; or
- requiring outflows of services to be measured at the cost of providing those services, ie without adding a service margin.

This paper explains those conclusions in more detail.

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1 Identifying liabilities

IAS 37 is contradictory and inconsistent with other Standards

1.1 A liability is a 'present obligation … arising from past events'. IAS 37 gives guidance on identifying present obligations. However, aspects of the guidance seem contradictory:

(a) on one hand, paragraph 19 of IAS 37 states that it is only obligations 'existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions'. This statement is often interpreted as meaning that liabilities must be unconditional—an entity does *not* have a liability for obligations that it could avoid through its future actions, even if those future actions are unrealistic.

(b) on the other hand, paragraph 10 of IAS 37 defines an obligating event as an event that 'results in the entity having no realistic alternative to settling the obligation'. This statement is often interpreted as meaning that an entity *does* have a liability for obligations that it could avoid through its future actions, *if* those actions are unrealistic.

1.2 These apparently inconsistent principles have given rise to problems in practice. It is unclear which principle should apply to transactions within the scope of, but not specifically addressed by, IAS 37 and stakeholders have expressed particular dissatisfaction with one interpretation, IFRIC 21 *Levies*.

New concepts have been developed to address these problems

1.3 The apparent inconsistencies in IAS 37 are symptomatic of a more general lack of clarity about the meaning of the term 'present obligation' in the definition of a liability. The IASB decided to address this problem as part of its Conceptual Framework project.

1.4 The *Conceptual Framework* Exposure Draft proposes new concepts to explain the term 'present obligation'. I think that these new concepts could result in:

(a) requirements for **levies** that are different from those in IFRIC 21 (see paragraphs 1.5-1.19 below);

(b) requirements for **restructuring costs** that are expressed differently from the way in which they are expressed in IAS 37. There would be a different process for identifying liabilities, but possibly not major differences in the timing of recognition of many restructuring costs (see paragraphs 1.20-1.27); and

(c) clearer **general guidance** that would reconcile, and could replace, the seemingly contradictory statements in IAS 37 (see paragraphs 1.28-1.30). The general guidance would not necessarily change the time at which other liabilities are identified. For example, I think that there might be no change to the requirements for the specific type of waste disposal obligation addressed by IFRIC 6 (see paragraphs 1.31-1.34).

Implications for levies

IFRIC 21 identifies liabilities only when obligations become unconditional

1.5 IFRIC 21 addresses levies that become payable only if and when a series of activities have all occurred. It applies the principle in paragraph 19 of IAS 37 that an obligation must exist independently of the entity's future actions. IFRIC 21 states that the event that gives rise to an obligation to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. There may be earlier activities that are also *necessary* for a levy to be payable, but because they are not *sufficient* by themselves to trigger the payment, they are not obligating events.

1.6 The consensus includes an example in which the activity that triggers the payment of a levy is the generation of any revenue in the *current* period, and the calculation of that levy is based on the amount of revenue that was generated in the *previous* period. The consensus states that the obligating event for that levy is the generation of revenue in the

current period. The generation of revenue in the previous period is necessary, but not sufficient, to trigger payment of a levy.[2]

1.7 In reaching its consensus, the IFRS Interpretations Committee considered an alternative view, ie that an obligation arises as soon as the amount of a levy starts to accumulate if the entity would have to take an unrealistic action (such as ceasing operations) to avoid the future activity that will trigger the levy. The basis of this view was that, in such situations, the entity is economically compelled to continue to operate and so will have no realistic alternative to paying the levy.

1.8 However, the Interpretations Committee rejected the argument on the basis that, if this rationale were applied, many types of future expenditure would be recognised as liabilities. The Interpretations Committee noted in particular the statement in IAS 37 that no provision is recognised for costs that need to be incurred to operate in the future.[3]

The result can be that a liability and an expense are recognised at a point in time

1.9 The requirements of IFRIC 21 lead to liabilities for some recurring periodic levies (such as the levy described in paragraph 1.6) being recognised in full at a point in time. The Interpretations Committee considered whether in some cases, the cost of the levy also gives rise to an *asset*—such as a licence to operate for the period. If so, the cost of the levy would not be recognised as an expense at that point in time. Instead, it would be recognised as an expense when the asset is amortised, which would be over the period up to the date of the next charge.

1.10 However, the Interpretations Committee decided that IFRIC 21 should not address the accounting treatment of the cost side of the transaction because other Standards (such as IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*) would determine whether the recognition of a liability to pay a levy gives rise to an asset or an expense.[4]

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2 IFRIC 21, paragraph 8.

3 IFRIC 21, Basis for Conclusions, paragraphs BC15-BC19.

4 IFRIC 21, paragraph BC11.

1.11 In practice, it is often not possible to identify an asset that is received by the entity in exchange for paying a levy and capable of being recognised applying another Standard. Accordingly, many levies that are recognised as liabilities at a single point in time must also be recognised as expenses at that point in time.

Stakeholders think IFRIC 21 does not faithfully represent periodic levies

1.12 IFRIC 21 has been criticised by a range of stakeholders, including users, preparers and auditors of financial statements and national standard-setters. Many of those criticising IFRIC 21 accept that it is a valid interpretation of IAS 37, but:

(a) some think that, in combination with Standards addressing the identification and recognition of assets, IFRIC 21 results in information that does not give a faithful representation of an entity's financial position and performance. They think that the economic substance of a recurring levy is that the entity is paying to operate over a period, although the law may identify a different activity that triggers the payment (such as being in operation at a specified date). They think that the substance of a recurring levy would be more faithfully represented by recognising the expense over the period to which the levy refers.

(b) some note that the requirements of IFRIC 21 are not consistent with the requirements of other IFRSs that address similar issues. For example, IFRS 2 *Share-based Payments* requires entities to recognise liabilities for cash-settled share-based payments. It requires an entity to recognise a liability when it receives the goods or services acquired in exchange for the share-based payment—even if at that time the payment is still subject to vesting conditions. Vesting conditions could include future performance targets, such as growth in profit. In such situations, the entity recognises a liability while it could still, in theory at least, avoid the future payment through its future actions.[5]

(c) some note that the requirements of IFRIC 21 also appear to be inconsistent with the requirements for other transactions within the scope of IAS 37, such as restructuring costs.

5 IFRS 2 *Share-based Payments*, paragraph 7, and definition of 'performance condition' in Appendix A.

The proposed concepts consider the entity's practical ability to avoid a transfer

1.13 The *Conceptual Framework* Exposure Draft proposes new concepts to explain the term 'present obligation'. It proposes that:

> 4.31 An entity has a present obligation to transfer an economic resource if both:
>
> (a) the entity has no practical ability to avoid the transfer; and
>
> (b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

1.14 The Exposure Draft notes that a present obligation could accumulate over time:

> 4.36 … If the economic benefits are received, or the activities are conducted, over time, a present obligation will accumulate over time (if, throughout that time, the entity has no practical ability to avoid the transfer).

1.15 The Exposure Draft proposes further guidance for situations in which the event that will trigger the transfer has not yet occurred:

> 4.35 In some situations, the requirement for an entity to transfer an economic resource may be expressed as being conditional on a particular future action by the entity, such as conducting particular activities or exercising particular options within a contract. The entity has an obligation if it has no practical ability to avoid that action.

1.16 The Exposure Draft also proposes to clarify the meaning of 'no practical ability':

> 4.32 An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

1.17 Thus, economic compulsion as discussed in paragraph 1.7 could be a factor in assessing whether an entity has the practical ability to avoid a future transfer. However, an inability to avoid a future transfer is not the only criterion for a present obligation—it is also necessary that the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation. Hence, economic compulsion alone is insufficient to create a liability.

Applying the proposed concepts, liabilities for some periodic levies would be recognised incrementally over the period to which the levy refers

1.18 I think that if the IASB were to apply the proposed new concepts to levies, it would specify requirements different from those in IFRIC 21: a liability might be identified before the entity conducts the activity that triggers payment of the levy. A liability would be identified earlier if:

(a) the amount of the levy is established by reference to earlier activities; and

(b) having conducted those earlier activities, the entity has no practical ability to avoid the future activities that will trigger the levy.

1.19 In the example discussed in paragraph 1.6, the obligating event *could* be the generation of revenue in the earlier period, with the liability accumulating over that period as the entity recognises the revenue on which the calculation of the levy is based. This earlier generation of revenue *would* be the obligating event if the entity judges that it has no practical ability to avoid generating further revenue in the next period. In many cases, the economic consequences of generating no revenue in the next period could be significantly more adverse than paying the levy and, accordingly, the entity might reach a judgement that it has no practical ability to avoid the levy.

Implications for restructuring costs

IAS 37 identifies liabilities when an entity has announced a restructuring plan

1.20 IAS 37 requirements for restructuring costs apply the principle that an entity has an obligation when it has no realistic alternative other than to transfer an economic resource. IAS 37 specifies that an obligation for the costs of restructuring a business arises when the 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.[6]

There are different views on whether an announcement creates an obligation

1.21 In the past, questions have been raised as to whether an announcement of a restructuring plan is really sufficient to create an obligation to carry out that plan. Those raising the issue have noted that such an announcement is not regarded as an obligating event applying US generally accepted accounting principles (US GAAP). The *Accounting Standards Codification* issued by the US Financial Accounting Standards Board (FASB) states that:

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6 IAS 37, paragraph 72.

> A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability included in FASB Concepts Statement No. 6, Elements of Financial Statements, is met. Only present obligations to others are liabilities under the definition. An obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. An exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability.[7]

The proposed concepts could reconcile the different views

1.22 I think that the proposed concepts described in paragraphs 1.13-1.17 above could help reconcile the differing views on whether the announcement of a restructuring plan is the event that gives rise to an obligation for the restructuring costs.

1.23 Applying the proposed concepts, two criteria both have to be satisfied for an entity to have a present obligation to transfer a resource:

(a) the entity must have no practical ability to avoid the transfer; and

(b) the obligation must have arisen from past events, ie the entity must have received the benefits or conducted the activities that establish the extent of its obligation.

1.24 A requirement to satisfy both criteria would support the view underpinning US GAAP, ie that the announcement of a restructuring plan is not sufficient on its own to create a present obligation. The proposed concepts would explain why an announcement is not sufficient: it is not in itself an activity that establishes the extent of any obligation—the act of announcing a plan does not result in an increase in the costs of carrying out that plan.

1.25 However, the need to also consider the entity's practical ability to avoid a future transfer would support the view of those who think that announcements of restructuring plans can give rise to new liabilities. An announcement could provide evidence that the entity no longer has the practical ability to avoid the future transfer. Accordingly, if the entity has

[7] FASB *Accounting Standard Codification*, Topic 420, Section 10-25 *Recognition*, paragraph 25-2.

already received the benefits or conducted the activities that establish the extent of a possible future transfer, the announcement of a restructuring plan could be the event that causes the other criterion (no practical ability to avoid) to be satisfied, and hence triggers the identification of a liability.

Example: Employment termination benefits arising from a restructuring

Background

An entity is required by law to make one-off payments to employees if it terminates their employment. The amount paid to each employee depends on the duration of that employee's past service. In the normal course of business, the entity rarely if ever needs to make termination payments. However, as a result of a recent acquisition, it now has excess production capacity. It has prepared a detailed formal plan for closing one factory and terminating the employment of all employees at that factory, and it has announced that plan to the employees.

Past events criterion

The past events criterion is satisfied over time, as the employees provide the service that increases the amount of termination benefits to which they would be entitled if their employment were terminated. The receipt of past employee service establishes the extent of the entity's obligation.

No practical ability to avoid criterion

In the normal course of business, the 'no practical ability to avoid' criterion is **not** satisfied as the employees provide their services. The entity rarely, if ever, has to terminate employment contracts so it has the practical ability to avoid make termination payments. Consequently, in the normal course of business, the entity does not have a present obligation for termination payments.

However, when an acquisition results in surplus production capacity, the entity becomes economically compelled to reduce that capacity as cost-effectively as possible. The announcement of the main features of the plan for closing a particular factory is evidence that the closure is the most cost-effective option available and, hence, that the entity no longer has the practical ability to avoid the termination payments. The announcement causes the entity to identify a liability for termination payments.

The practical implications might not be great

1.26 Thus, although applying the proposed new concepts to IAS 37 could change the wording of the requirements for restructuring costs, the practical implications might not be great. Entities would be required to recognise liabilities for each cost only when both of the two general criteria for identifying a present obligation are satisfied. However, the announcement of a restructuring plan could be identified as an event that provides evidence that the 'no practical ability to avoid' criterion has been satisfied and so could be an event that triggers the recognition of liabilities for some costs.

1.27 A plan to restructure an operation is also identified in IAS 36 *Impairment of Assets* as a trigger for impairment reviews of assets used in that operation.[8] Accordingly, a restructuring plan would remain a potential trigger for identifying both liabilities (including liabilities for contracts that become onerous as a result of the restructuring) and impairment losses.

Implications for general guidance on identifying liabilities

1.28 The scope of IAS 37 is broad. It encompasses most liabilities that are not within the scope of another Standard. This means that it encompasses many non-contractual obligations, including many obligations imposed by governments. New types of obligation emerge from time to time and IAS 37 has to be able to cope with them.

Existing guidance is difficult to apply

1.29 As discussed in paragraphs 1.1-1.2 of this paper, the guidance in IAS 37 on identifying a present obligation is unclear and seemingly contradictory. There seem to be two different underlying principles, and no obvious way of identifying which principle should apply when they conflict. It is therefore difficult to identify the correct principle to apply to new transactions that are within the scope of IAS 37, but for which IAS 37 has no specific application guidance.

[8] IAS 36, paragraph 12(f).

The proposed concepts could provide clearer guidance

1.30 The proposed new concepts would provide a more precise definition of 'as a result of past events' and would reconcile the seemingly contradictory statements in IAS 37. The concepts could replace the existing guidance, making IAS 37 better able to cope with new types of transaction that emerge from time to time.

The proposed concepts might not change requirements for obligations within IFRIC 6

1.31 The general guidance would not necessarily change the time at which many obligations within the scope of IAS 37 are identified as liabilities. For example, I think that there might be no change to the requirements for the specific type of waste disposal obligation addressed by IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*.

1.32 IFRIC 6 applies to an obligation that the European Union directed its Member States to impose on producers of electrical and electronic equipment. The obligation was to contribute to costs of disposing of 'historical waste', ie household equipment manufactured before August 2005. The Directive required Member States to allocate the costs among producers in proportion to each producer's market share during a specified period (the 'measurement period'). The Directive allowed each Member State to choose its own measurement period.

1.33 The IFRIC consensus was that the obligating event is participation in the market during the measurement period. In reaching its consensus, the IFRIC considered an argument that the obligation arises from an earlier activity—the manufacture or sale of equipment that would become historical waste. However, the IFRIC rejected this argument on the grounds that an obligation must arise independently of an entity's future actions. Unless and until a producer participates in the relevant market during the measurement period, any obligation is dependent on its future participation.[9]

[9] IFRIC 6, paragraphs 9, BC9 and BC10.

1.34 I think that, if the IASB were to apply the concepts proposed in the *Conceptual Framework* Exposure Draft to this particular obligation, it might not change the consensus in IFRIC 6—it could identify participation in the market during the measurement period as the event that gives rise to a present obligation. However, the rationale might be different from that underpinning the consensus in IFRIC 6. The rational might be that an entity has a present obligation only if it has received the benefits or conducted the activities that establish the extent of its obligation, and has no practical ability to avoid a future transfer. In the case of historical waste, the activity that establishes the extent of a particular producer's obligation is its participation in the relevant market during the measurement period. And having participated in the market, the producer would have an unconditional obligation for its share of the costs so it would have no practical ability to avoid them.

2 Recognition criteria

Recognition is an important aspect of IAS 37

2.1 'Recognition' of an asset or a liability is the inclusion of the asset or liability at a monetary amount in relevant totals in the statement of financial position. Recognition requires a single monetary amount to be assigned to the liability.

2.2 IAS 37 was developed to address liabilities that are subject to uncertainty. Some of those liabilities (such as contractual warranty obligations) are subject only to 'outcome uncertainty'—it is certain that the entity has a liability but uncertain what outflows, if any, will be required to settle the liability. Others (such as a possible liability to pay damages for an alleged act of wrong-doing) are also subject to significant 'existence uncertainty'—ie, the existence or non-existence of the liability is disputed and will be confirmed only on the occurrence of a future event, such as a court ruling.

2.3 In the face of significant existence or outcome uncertainty, the question of whether a particular liability should be assigned a single monetary amount and recognised in the financial statements is an important one.

IAS 37 specifies three recognition criteria

2.4 IAS 37 specifies that liabilities within its scope should be recognised if three recognition criteria are all met:

(a) if, on the basis of all available evidence, it is more likely than not that a present obligation exists; and

(b) if it is probable (= more likely than not) that an outflow of resources will be required to settle the obligation; and

(c) if a reliable estimate can be made of the amount of the obligation.[10]

[10] IAS 37, paragraphs 14, 15 and 23.

2.5 The recognition criteria are consistent with existing concepts. The 'probable outflows' and 'reliable estimate' criteria mirror the two recognition criteria specified in the existing *Conceptual Framework*.[11] There is no specific reference to existence uncertainty in the existing *Conceptual Framework*.

2.6 IAS 37 notes that, 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 reliable for recognition.

The IASB previously proposed to remove the 'probable outflows' criterion

2.7 The recognition criteria in IAS 37 have been the subject of much debate in the past. The debate has focused on the 'probable outflows' recognition criterion.

2.8 Although the criterion is specified in the existing *Conceptual Framework*, it is not in other Standards. In particular, when the IASB revised IFRS 3 *Business Combinations*, it decided to omit the probable outflows criterion from that Standard. The IASB's reasons were that:

(a) an asset or a liability should be recognised if it satisfies the definitions in the *Framework*. Otherwise the financial statements are incomplete.

(b) if there is a low probability of a future outflow, that factor can be reflected by measuring the liability at an amount that reflects the low probability.[12]

2.9 In its previous project to amend IAS 37, the IASB also proposed to remove the probable outflows criterion from IAS 37. The IASB's main reasons were that:

(a) the amendment would ensure that all liabilities within the scope of IAS 37 were treated consistently, regardless of whether they had been assumed in a business combination or incurred separately.[13]

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11 *The Conceptual Framework for Financial Reporting*, paragraphs 4.38 and 4.46.

12 IFRS 3, paragraph BC272.

13 Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, June 2005, paragraph BC22.

(b) recognition of a liability can provide useful information, even if outflows are not probable. For example, an increase in the amount recognised from one period to the next can give an early indication of a change in management's assessment of the probability, or possible amount, of future cash flows.

(c) probability would still play a role in recognition if it is uncertain whether a liability exists.

(d) the probable outflows criterion was inconsistent with the IASB's proposal to require entities to measure liabilities within the scope of IAS 37 at 'expected value', ie to take into account all possible outcomes and their probabilities.[14]

Many stakeholders argued that the probable outflows criterion serves a useful purpose

2.10 Most respondents to the 2005 Exposure Draft opposed the IASB's proposal to remove the probable outflows criterion from IAS 37. And many went on to reiterate their opposition when responding to the IASB's limited scope re-exposure of revised proposals for measurement, published in 2010. Respondents to the two Exposure Drafts expressed views that:

(a) recognition of liabilities for which there is only a low probability of a cash outflow does not provide relevant financial information. Disclosure provides more useful information.

(b) the cost to financial statement preparers of recognising and measuring low probability liabilities may outweigh the benefits to users. The cost of identifying all the possible outcomes and estimating the probability of each is disproportionate to the amounts likely to be recognised.

(c) the probable outflows criterion is a useful filter that avoids the need for consideration of whether a liability exists. In its absence, IAS 37 would be more complex to apply, leading to greater diversity.

[14] IASB *Update* June 2006

(d) without the probable outflows criterion, entities might need to identify and recognise liabilities for undetected acts of wrongdoing. Recognition would increase the risk of future detection and prejudice the outcome of any action taken against the company.

(e) consistency with other standards, such as IFRS 3, is not important. Differences in the nature of the transactions—especially for assets and liabilities acquired in a business combination—justify different requirements. The different criteria have not caused major problems for users or preparers.

(f) The IASB should change conceptual criteria only after wider debate within the conceptual framework project. Accordingly, any revisions to IAS 37 should be postponed until the IASB completed its review of the *Conceptual Framework*.[15]

The Conceptual Framework Exposure Draft proposes a new approach

2.11 The *Conceptual Framework* Exposure Draft proposes a new approach to recognition.

2.12 Whereas the existing *Conceptual Framework* specifies two specific recognition criteria (probable outflows and reliable measurement) that should be applied in all Standards, the Exposure Draft proposes that recognition requirements may need to vary between Standards.[16] It explains that:

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[15] This list combines comments received on:

(a) the 2005 Exposure Draft (see IASB meeting February 2006, Appendix to Agenda Paper 8, *Comment Letter Summary*, paragraphs 36-43);and

(b) the 2010 Exposure Draft (see IASB meeting, September 2010, Appendix A to Agenda Paper 7 *Liabilities—amendments to IAS 37, Comment letter summary*).

[16] *Conceptual Framework* Exposure Draft, paragraph 5.10.

> 5.9 Failure to recognise items that meet the definition of an element makes the statement of financial position and the statement(s) of financial performance less complete and can exclude useful information from financial statements. On the other hand, in some circumstances, the recognition of some items that meet the definition of an element can provide information that is not useful. An entity recognises an asset or a liability (and any related income, expenses or changes in equity) if such recognition provides users of financial statements with:
>
> (a) relevant information about the asset or the liability and about any income, expenses or changes in equity;
>
> (b) a faithful representation of the asset or the liability and of any income, expenses or changes in equity; and
>
> (c) information that results in benefits exceeding the cost of providing that information. [Cross references omitted.]

2.13 The *Conceptual Framework* Exposure Draft goes on to provide further guidance. Of particular note for liabilities within the scope of IAS 37 is its proposals that:

(a) recognition may not provide relevant information:

(i) if it is uncertain whether an asset or a liability exists;

(ii) if an asset or a liability exists, but there is only a low probability that an inflow or outflow of economic benefits will result; or

(iii) if all of the measurements of a liability that could be obtained have such a level of measurement uncertainty that that the resulting information has little relevance.[17]

(b) it will often be a combination of these factors, instead of any single factor, that causes information to lack relevance.[18]

[17] *Conceptual Framework* Exposure Draft, paragraph 5.13.

[18] *Conceptual Framework* Exposure Draft, paragraph 5.14.

Existence uncertainty

2.14 In its discussion of existence uncertainty, the *Conceptual Framework* Exposure Draft specifically refers to a type of liability that is within the scope of IAS 37 and for which recognition may not provide relevant information:

> 5.16 For some liabilities, it may be unclear whether a past event causing an obligation has occurred. For example, if another party claims that the entity has committed an act of wrongdoing and should compensate the other party for that act, it may be uncertain whether the act occurred or whether the entity committed it. In some such cases, the uncertainty about the existence of an obligation, possibly combined with a low probability of outflows of economic benefits and a high level of measurement uncertainty, may mean that the recognition of a single amount would not provide relevant information. Whether or not the liability is recognised, disclosures about the uncertainties associated with the liability may be needed.

Low probability of an inflow or outflow of economic benefits

2.15 In its discussion of assets and liabilities with a low probability of inflows or outflows, the *Conceptual Framework* Exposure Draft proposes that:

> 5.18 Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or the liability may provide relevant information, especially if the measurement of the asset or the liability reflects the low probability and is accompanied by explanatory disclosures. For example, if an asset is acquired, or a liability is incurred, in an exchange transaction for an observable price, its cost reflects the low probability that economic benefits will flow and that cost may be relevant information.
>
> 5.19 However, users of financial statements may, in some cases, not find it useful for an entity to recognise assets and liabilities with very low probabilities of inflows and outflows of economic benefits.

Measurement uncertainty

2.16 In its discussion of measurement uncertainty, the *Conceptual Framework* Exposure Draft proposes concepts that closely reflect the guidance in IAS 37. It notes that the use of reasonable estimates is an essential part of the preparation of financial statements and does not necessarily undermine their usefulness.[19] However, it goes on to give examples of situations in which a high level of measurement uncertainty may contribute to information having little relevance, including a situation in which:

> 5.21(a) the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. In such cases, the most relevant information for users of financial statements might relate to the range of outcomes and the factors affecting their likelihoods. When that information is relevant (and can be provided at a cost that does not exceed the benefits), disclosure of that information in the notes to the financial statements may be appropriate, regardless of whether the entity also recognises the asset or liability. However, in some cases, trying to capture that information in a single number may not provide any further relevant information. …

The proposed concepts could support the existing criteria in IAS 37

2.17 If the IASB were to revisit the IAS 37 recognition criteria and consider the proposed concepts, it could reach different conclusions from those it reached in its previous project to amend IAS 37. The proposed concepts acknowledge that recognition requirements may need to vary between Standards. Hence, applying the proposed concepts, consistency with other Standards would not in itself be a reason for removing the probable outflows criterion from IAS 37.

2.18 Liabilities within the scope of IAS 37 have characteristics that are different from those of other liabilities and that might justify different recognition criteria. Existence uncertainty can be a more important factor for some liabilities within the scope of IAS 37 than for

[19] *Conceptual Framework* Exposure Draft, paragraph 5.20.

many other liabilities. But even once existence uncertainty has been addressed, there are other differences to consider.

2.19 Most liabilities within the scope of IAS 37 have one particular characteristic that tends to distinguish them from many other liabilities: they cannot be measured by reference to an observable transaction price. They tend not to be traded, so do not have an observable *current* transaction price. Perhaps more unusually, there is typically no exchange transaction that provides an observable *historical* transaction price for the liability (proceeds that the entity received in exchange for incurring the liability). For example:

(a) liabilities for acts of wrongdoing, environmental rehabilitation obligations and other obligations imposed by governments arise from an entity's activities, not from a direct exchange transaction; and

(b) although warranty obligations arise from a direct exchange transaction, those within the scope of IAS 37 do not have an observable transaction price: warranty obligations are within the scope of IAS 37 only if the customer does not have the option to purchase the warranty separately.[20]

2.20 Where they exist, observable transaction prices (whether historical or current) can often be obtained at a relatively low cost, take into account the probability of future inflows or outflows and are usually subject to relatively little measurement uncertainty. Consequently, even if the only observable transaction price for a liability is a historical one, there is likely to be at least one measure of the liability for which the benefits of recognition exceed the costs—further recognition criteria may not be necessary. It could be argued that the need for recognition criteria in IAS 37 stems in part from the absence of *any* observable transaction price.

2.21 I have not identified any obvious conflicts between the existing IAS 37 criteria and the proposed concepts. Indeed there is considerable alignment. The *Conceptual Framework* Exposure Draft specifically identifies existence uncertainty, a low probability of outflows and exceptionally high measurement uncertainty as factors that, individually or in combination, may cause the information provided by recognition to lack relevance. And

[20] IFRS 15 *Revenue from Contracts with Customers*, paragraph B30.

the *Conceptual Framework* Exposure Draft envisages information being disclosed about liabilities with high measurement uncertainty (see the extract below paragraph 2.16) that is very similar to the information required by IAS 37.

2.22 Some people might interpret the proposed concepts as suggesting recognition thresholds somewhat lower than those applied at present in IAS 37. For example:

(a) the *Conceptual Framework* Exposure Draft envisages that recognition of a particular liability may not provide useful information if there is only a 'low' probability of outflows. Low is not defined. But some people might argue that the 50% threshold in IAS 37 filters out more liabilities than just those with 'low' probabilities—a probability of 45%, say, is not particularly low.

(b) the *Conceptual Framework* Exposure Draft states that it will often be a combination of factors (existence uncertainty, a low probability of outflows and exceptionally high measurement uncertainty) that lead to a conclusion that recognition would not provide sufficiently useful information to justify the cost. IAS 37 requires only one of these factors to be present for non-recognition of a liability (if the liability fails any one of the three recognition criteria, it is not recognised).

2.23 Accordingly, if the IASB were to apply the proposed concepts to the recognition criteria in IAS 37, it might consider whether the existing thresholds are too high. However, when the IASB develops new financial reporting requirements, the IASB's objective should be to address problems with the existing requirements.[21] Combining this objective with the recognition concepts proposed in the *Conceptual Framework* Exposure Draft suggests that the IASB would consider lowering the existing thresholds only if it has evidence that:

(a) there are examples in practice of liabilities that do not satisfy existing IAS 37 recognition criteria but whose recognition would provide useful information to investors, lenders or other creditors; and

(b) the costs of recognising these liabilities would not exceed the benefits.

2.24 The IASB could consult users and preparers of financial statements to identify any such liabilities.

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[21] *IASB and IFRS Interpretations Committee Due Process Handbook*, paragraph 4.6.

3 Measurement

Existing IAS 37 measurement requirements are unclear

3.1 IAS 37 requires entities to measure liabilities at 'the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'. It adds that this amount is the 'amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time'.[22]

3.2 This amount is typically determined by estimating the future cash flows required to settle the liability. IAS 37 specifies that:

(a) where the effect of the time value of money is material, entities should discount the future cash flows to their present value, using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the liability; and

(b) entities should take into account risks and uncertainties—a risk adjustment may increase the amount at which a liability is measured.[23]

3.3 However, as detailed further in Agenda Paper 14B *Possible problems with IAS 37*, aspects of the measurement requirements are unclear. In particular:

(a) many liabilities within the scope of IAS 37 have a range of possible outcomes. It is unclear whether the cash flows used to measure single obligations should be the most likely outflows, the expected value (probability-weighted average) of all possible outflows or some other amount within the range. There is evidence of diversity in practice.

(b) unlike many other Standards, IAS 37 does not specify the types of costs that entities should include in estimates of future cash flows. Entities include at least the incremental costs of materials and services. However, practices vary on the

22 IAS 37, paragraphs 36-37.

23 IAS 37, paragraphs 42-47.

extent to which they also include less direct costs, such as an allocation of fixed or variable overheads.

(c) IAS 37 does not identify the precise objectives of the risk adjustment, or clarify the circumstances in which a risk adjustment would be required, or explain how a risk adjustment should be measured. Differences in understanding give significant scope for diversity in the amounts at which provisions are measured.

(d) IAS 37 does not specify whether the measurement should take into account the risk of non-performance by the entity (sometimes called the entity's 'own credit' risk). Including the effects of non-performance risk can substantially reduce the measure of very long-term liabilities, such as decommissioning and environmental rehabilitation liabilities. While the predominant practice appears to be to exclude the effects of non-performance risk, some entities—concentrated in some jurisdictions and sectors—include it.[24]

The IASB previously proposed more precise requirements

3.4 In its previous project to amend IAS 37, the IASB proposed to clarify the measurement requirements. It proposed that:

(a) an entity should measure a liability at the amount it would rationally pay at the end of the reporting period to be relieved of its obligation.

(b) this amount is the lowest of:
   (i) the present value of the resources required to fulfil the obligation;
   (ii) the amount that the entity would have to pay the counterparty to cancel the obligation; and
   (iii) the amount that the entity would have to pay to transfer the obligation to a third party.

(c) if there is no evidence that the entity could cancel or transfer the obligation, the entity should measure the liability at the present value of the resources required to fulfil the obligation.

[24] IFRIC *Update*, March 2011, IFRS Interpretations Committee agenda decisions.

(d) the present value of the resources required to fulfil the obligation should be measured by:

(i) identifying each possible outcome and estimating the amount and timing of the resource outflows for that outcome;

(ii) discounting those outflows to their present value, using current market assessments of the time value of money;

(iii) calculating the probability-weighted average of those present values; and

(iv) including a risk adjustment, ie a measure of the amount the entity would rationally pay to be relieved of the risk that the actual outflows of resources might ultimately differ from those expected.

(e) for obligations to provide services, the outflows would be the services, measured at their estimated market price when performed. In an absence of a market for the services, the entity would estimate the price it would charge another party to perform the service for that other party, taking into account both the estimated costs and an estimate of the margin it would require.[25]

3.5 The IASB proposed to require outflows of services to be measured at the price, rather than the cost of those services on the basis that:

(a) this requirement is consistent with the measurement objective: the amount that an entity would rationally pay to be relieved of an obligation to transfer a resource would reflect the value, not the cost, of that resource.

(b) there is a market for most types of service. The discipline of using observable market prices reduces subjectivity.

(c) a transaction price objective would avoid the need for detailed (and potentially arbitrary) rules specifying the types of costs to include in the measurement.

(d) if an entity measured a liability at cost, it would recognise no profit when it fulfilled the liability. However, all of an entity's activities are necessary for it to generate revenue. For example, to sell oil, an entity must construct, operate and decommission

[25] Exposure Draft *Measurement of Liabilities in IAS 37*, January 2010, paragraphs 36A-C and Appendix B.

an oil rig. The entity should attribute the profit it earns to all of these activities, not just the activities it has completed when it delivers oil to customers.[26]

Stakeholders opposed key aspects of the previous proposals

3.6 Some respondents to the Exposure Draft—including several groups representing users of financial statements—welcomed the measurement proposals.

3.7 However, many respondents opposed three key aspects of the proposals:

(a) Many respondents opposed the proposal to require entities to measure all liabilities by reference to the expected value (probability-weighted average) of the possible outcomes. They argued that for some obligations—especially large one-off litigation liabilities—:

(i) the most likely outcome is more relevant.

(ii) it is often not possible to make reliable estimates of the full range of possible outcomes and their associated probabilities. The difficulties could lead to fewer liabilities being recognised.

(iii) even in cases where reasonable estimates could be made of the range of possible outcomes and their associated probabilities, the costs of doing so would often exceed the benefits.

(iv) measuring liabilities at expected value could prejudice the outcome of lawsuits conducted in the United States. Defendants would have to disclose more information about the possible outcomes to their auditors, so more information would be at risk of losing its attorney-client privilege. Furthermore, the amount recognised would be viewed as a floor by the other party in a negotiated settlement.[27]

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26 Exposure Draft *Measurement of Liabilities in IAS 37*, January 2010, paragraph BC21.

27 IASB Agenda Paper 7 (Appendix A), *Liabilities—comment letter summary*, September 2010, Section 3.3.

(b) Virtually all respondents—including most groups representing users of financial statements—opposed the proposal to measure outflows of services at the market price of those services, ie to include both the estimated costs and a margin. Respondents give several different reasons:

(i) some thought that the amounts recognised in the income statement would not be relevant. The inclusion of hypothetical margins overstates the expenses of the period in which the liability is recognised, and overstates profits in the later period when the liability is released. This outcome distorts the income statement and deprives users of relevant information about the underlying profitability of the business.

(ii) some thought that the proposal was not consistent with the measurement objective. In their view, the amount an entity would rationally pay to be relieved of an obligation is the lower of the cost of fulfilling that obligation and of outsourcing it: the opportunity cost of the service is an upper boundary.

(iii) some observed that, although entities can contract out some services (such as some types of decommissioning obligation) there are rarely observable market prices for those services. They thought that estimates of margins could be very subjective.

(iv) some suggested that guidance specifying the costs to be included in the measurement of the liability need not be arbitrary or detailed—IAS 2 *Inventories* is applied without problems.

(v) some noted that entities are not permitted to recognise hypothetical margins on other activities (such as construction of property, plant or equipment for use within the business).[28]

(c) Many respondents—including most of the auditors and user groups—expressed concerns about the proposal to require a risk adjustment, and the lack of guidance on how to measure it. Some respondents questioned whether entities can reliably measure risk adjustments for liabilities within the scope of IAS 37, noting that

[28] IASB Agenda Paper 7 (Appendix A), *Liabilities—comment letter summary*, September 2010, Section 3.4.

methods used by insurers for large pools of risks cannot be applied to single obligations. Some respondents suggested that a requirement to add a risk adjustment might give managers unwarranted latitude to manipulate the liability, reducing comparability. Some suggested that users would better served by disclosure of the risks and the range of possible outcomes.[29]

The proposed concepts could lead the IASB to different conclusions

3.8 The *Conceptual Framework* Exposure Draft proposes that:

> 6.3 Consideration of the objective of financial reporting, the qualitative characteristics of useful information and the cost constraint is likely to result in the selection of different measurement bases for different assets, liabilities and items of income and expense.

3.9 The Exposure Draft goes on to describe factors to consider when selecting a measurement basis. Perhaps particularly relevant for IAS 37 is the proposal that, in selecting a measurement basis for an asset or a liability, it is important to consider how that asset or liability contributes to future cash flows.[30] This proposal could lead the IASB to conclude that entities should measure liabilities within the scope of IAS 37 by reference to the intended method of settlement—not the lowest cost method of settlement.

3.10 Entities tend to settle most liabilities within the scope of IAS 37 by fulfilling the obligations themselves: the nature of the obligations is such that entities typically do not have the practical ability (or sometimes even a legal right) to transfer the obligations to another party, or to negotiate release with the counterparty. The predominance of fulfilment as the method of settlement could lead the IASB to focus on 'fulfilment value' when developing measurement requirements for IAS 37.

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29 IASB Agenda Paper 7 (Appendix A), *Liabilities—comment letter summary*, September 2010, Section 3.5.

30 *Conceptual Framework* Exposure Draft, paragraph 6.54(a).

3.11 The *Conceptual Framework* Exposure Draft defines fulfilment value as the present value of the cash flows that an entity expects to incur as it fulfils a liability. It proposes that, in principle, fulfilment value reflects the same factors as fair value, but measured from the perspective of the entity, instead of a market participant. However, the *Conceptual Framework* Exposure Draft states that, in practice, fulfilment value may sometimes need to be customised to provide the most useful information, for example:

(a) to use market participant assumptions about the time value of money or the risk premium; or

(b) to exclude the effect of the possibility of non-performance by the entity.[31]

3.12 The *Conceptual Framework* Exposure Draft notes the importance of considering the information that a particular basis will produce in both the statement of financial position and the statement(s) of financial performance.[32] Of particular relevance to IAS 37 is a proposal relating to information produced in the statement(s) of financial performance for liabilities incurred in a transaction that involves no exchange. As discussed in paragraphs 2.19(a) above, liabilities within the scope of IAS 37 are often incurred without a direct exchange. Regarding such liabilities, the *Conceptual Framework* Exposure Draft proposes that:

> 6.36 When an entity incurs a liability in a transaction that involves no exchange and measures it on initial recognition at the fulfilment value, the expense recognised at that date includes a risk premium. As the entity is subsequently released from risk, the liability is reduced and income is recognised. Users may sometimes find that effect counterintuitive. [Cross references omitted.]

3.13 These proposals suggest that, if the IASB were to specify a form of 'fulfilment value' measurement basis in IAS 37, it should consider whether, and if so how, to customise that basis to provide the most useful information about the liability and the expense, and to take into account the cost constraint. Previous stakeholder feedback suggests that, if the IASB were to take this approach, it might consider:

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31 *Conceptual Framework* Exposure Draft, paragraph 6.34-6.35.

32 *Conceptual Framework* Exposure Draft, paragraph 6.53.

(a) permitting or requiring entities to measure some liabilities by reference to the most likely outcome (with disclosure of information about the other possible outcomes) instead of the expected value (probability-weighted average) of all possible outcomes;

(b) excluding the effects of non-performance risk, and possibly excluding any risk adjustment (especially in the absence of any form of observable market prices for risk); or

(c) requiring outflows of services to be measured at the cost of providing those services, ie without adding a service margin.

3.14 The IASB could conduct further research and consultation before reaching preliminary views on these matters.