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**International
Accounting Standards
Board**

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: Wednesday 16 April 2008, London

Project: IAS 37 Short-term convergence amendments

Subject: General requirements for restructuring costs and specific guidance for contract termination costs – comment analysis (Agenda Paper 5A)

Introduction

- 1 This paper provides an analysis of comments received on the proposed amendments for restructuring provisions.

Differences between IAS 37 and SFAS 146

- 2 The major differences between the current IAS 37 and SFAS 146's requirements for restructurings are that:
 - (a) the current IAS 37 requires entities to recognise at a specified point a single liability (provision) for restructuring costs, whereas SFAS 146 requires entities to recognise a liability for each *individual* cost in a restructuring only when the entity has incurred an obligation for that cost, with no single liability for restructuring.

(b) unlike the current IAS 37, SFAS 146 does not regard an announcement by management of a proposed restructuring as sufficient in itself to give rise to a constructive obligation.

(c) due to the different recognition criteria in the two standards, liabilities may be recognised earlier applying the current IAS 37 than they would be applying SFAS 146.

3 So to put it simply, IAS 37 typically results in an entity recognising one large expense before the restructuring commences, whereas SFAS 146 results in expenses being recognised over the duration of the restructuring. Furthermore, the expense applying IAS 37 could be recognised before any of the expenses are recognised applying SFAS 146.

Current IAS 37	SFAS 146
<p>(IAS 37.72) A constructive obligation to restructure arises only when an entity:</p> <p>a.) has a detailed formal plan for the restructuring identifying at least:</p> <ul style="list-style-type: none"> • the business or part of a business concerned • the principal locations affected • the location, function, and approximate number of employees who will be compensated for terminating their services • the expenditures that will be undertaken • when the plan will be implemented <p>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.</p>	<p>(SFAS 146.03) Recognition and measurement</p> <p>A liability for a cost associated with an exit or disposal activity shall be recognized and measured initially at its fair value in the period in which the liability is incurred, except as indicated in paragraph 11 (for a liability for one-time termination benefits that is incurred over time). In the unusual circumstances in which fair value cannot be reasonably estimated, the liability shall be recognized initially in the period in which fair value can be reasonably estimated.</p> <p>(SFAS 146.04) A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability is met. Paragraph 35 of FASB Concept Statement No. 6, Elements of Financial Statements, defines liabilities as follows:</p> <p>“Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”</p>

Board considerations on liabilities for restructuring costs

- 4 In the light of the FASB's conclusions in SFAS 146, the Board considered whether a restructuring plan together with its announcement gives rise to a liability by imposing on the entity a constructive obligation to restructure.
- 5 It noted the guidance in paragraph 17 of IAS 37 that an obligating event requires the entity to have 'no realistic alternative to settling the obligation' and, therefore, considered whether a restructuring plan and its announcement leave the entity in that position. The Board reasoned that, even if an entity has announced its restructuring plan in a general way, it has no *obligation* to others and is not bound by its plan to the extent that it cannot avoid an outflow of resources. The Board decided that because an entity can recall its restructuring plan once it has been announced, the restructuring guidance in the present version of IAS 37 is a misapplication of the Standard's notion of a constructive obligation.
- 6 The Board decided that these deficiencies could be addressed, and convergence achieved, by aligning the requirements of IAS 37 with those of SFAS 146. Accordingly, the Exposure Draft proposed to withdraw the present requirements for the recognition of restructuring provisions in IAS 37 and state that liabilities arising from costs associated with a restructuring should be recognised on the same basis as if that cost arose independently of a restructuring, namely when the entity incurs a liability that can be measured reliably. Thus, instead of an entity recognising at a specified point a single liability for all the costs associated with a restructuring, it would recognise liabilities for each cost associated with the restructuring when the obligation for each cost is incurred.

Comment analysis

- 7 Of the 123 comment letters received, 83 specifically commented on the question relating to restructuring provisions.

	Agreed	Disagreed	No Comment
Question 9 (a) – Do you agree with recognising each liability when it is incurred?	50%	20%	30%
Question 9 (b) – Is the guidance for applying the principles in the Exposure Draft to restructuring costs appropriate?	50%	-	50%

- 8 The majority of the respondents agreed with the proposed changes and acknowledged that they should result in more faithful representation of liabilities incurred in restructurings.
- 9 However, some of these respondents shared the concerns of those disagreeing with the proposals. The main concerns were that:
- A useful information about restructurings that is provided under the current requirements might be lost, and
 - B the constructive obligation concept had been applied inconsistently.

Concern A: Useful information might be lost

Respondent comments

- 10 A few respondents disagreed with the proposals because they thought that recognising at a specified point a single liability for all of the expected costs provided better information. They noted that the individual costs of restructuring could be recognised in different accounting periods as a result of proposed changes. They thought that the financial information provided in each period would be less meaningful to users because the total cost of restructuring would not be reflected anywhere in the financial statements.
- 11 Several respondents (those who agreed and those who disagreed with the proposal) suggested that the final Standard should include specific disclosure requirements for restructurings because users regard corporate restructurings as important events. These disclosures could include a description of the restructuring, the segment affected, the expected total costs and the expected timing of those costs.

It might be helpful to have uniform disclosures with regard to restructuring including, for example, a description of the restructuring and the segment affected, any impairment charges recognised, the total costs associated with the restructuring and the timing of costs. Preparers will be disappointed at the disappearance of a 'single charge' approach to restructuring but may find it helpful to replace this with structured uniform disclosures, including the total expected cost. [CL74]

We agree, but given that most preparers would prefer a single line item, we believe that it would be relevant to provide additional note disclosure with regard to the restructuring, such as detail of the restructuring plan, including the total estimated costs and the expected nature and timing of these costs. [CL43]

- 12 Some respondents noted that costs involved in a restructuring may be incurred over a long period of time as the restructuring progresses. The recognition of these costs may need additional disclosure to assist users in understanding how the restructuring is affecting profit or loss. This will particularly be the case if in a period the entity recognises costs relating to a restructuring process that was announced, say, 12 to 18 months ago.

Staff evaluation and recommendation

- 13 In the Exposure Draft, there are no specific disclosure requirements for restructuring costs. However, entities may be required by other standards or regulatory requirements to disclose information about planned restructurings. For example, if a restructuring was announced after the end of the reporting period, IAS 10 *Events after the Reporting Period* would require disclosure of an estimate of its financial effect. There is also the general requirement in IAS 1 *Presentation of Financial Statements* for financial statements to present fairly the financial position, financial performance and cash flows of the entity. Paragraph 17(c) notes that a fair presentation requires an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance. However, IAS10 and IAS1 do not create specific disclosure requirements for restructuring.
- 14 Therefore, the staff agree that as a result of no longer recognising a single restructuring provision some information that is currently provided in IAS 37 might be lost that could be helpful to users in evaluating the effect of a restructuring.
- 15 SFAS 146 has detailed disclosure requirements for restructurings and the Board could consider adding similar requirements to IAS 37. The disclosure requirements of SFAS 146 are:
- 20 The following information shall be disclosed in notes to financial statements that include the period in which an exit or disposal activity is initiated (refer to paragraph 21) and any subsequent periods until the activity is completed:
- a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date
 - b. For each major type of cost associated with the activity (for example, one-time termination benefits, contract termination costs, and other associated costs):

- (1) The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date
 - (2) A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) therefor
 - c. The line item(s) in the income statement or the statement of activities in which the costs in (b) above are aggregated
 - d. For each reportable segment, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any adjustments to the liability with an explanation of the reason(s) therefor
 - e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons therefor.
- 16 In its Basis for Conclusions in SFAS 146, the FASB concluded that these disclosure requirements focus on the major types of costs associated with an exit or disposal activity and that they provide information that is useful to investors, creditors and other users in assessing the overall effects of the activity of an entity's ongoing operations.
- 17 The FASB concluded that the reconciliation format would improve the comparability of information provided about exit and disposal activities and aid users in assessing the effect of such activities over time, including the related cash flow implications. The FASB also concluded that information about the costs the entity expects to incur in connection with an exit or disposal activity is useful in assessing the effects of the activity initially and over time. For that reason, the FASB decided to require disclosure of major types of costs expected to be incurred in connection with the exit or disposal activity at the date the entity initiates a plan, whether or not a liability for those costs is recognised at that date.

- 18 Although the disclosure requirements in SFAS 146 are substantial for a single event such as a restructuring, they address the needs raised by respondents (refer to CL74 and CL43 in paragraph 11). Compared to the current disclosure requirements of provisions in IAS 37, SFAS 146 requires disclosure of similar information specifically for a restructuring.
- 19 The staff recommend that the Board include the disclosure requirements similar to those of SFAS 146 in the amended IAS 37. The final drafting and wording of the suggested disclosure will be discussed with the Board in a future paper.

Questions for the Board

Do you agree that the disclosure requirements in SFAS 146 for restructurings would be appropriate in IAS 37?

Concern B: Inconsistent application of the constructive obligation concept

- 20 The Exposure Draft proposed that an entity should recognise a non-financial liability for a cost associated with a restructuring only when the definition of a liability has been satisfied. The Exposure Draft also stated that a decision by the management of an entity to undertake a restructuring does not create a present obligation to others for costs expected to be incurred during the restructuring.

Respondent comments

- 21 Most of the respondents who disagreed with the proposed changes argued that it is possible for a constructive obligation for restructuring costs to exist before the individual liabilities for each cost are incurred. This is because they think an entity may make a sufficiently specific current statement to the extent that it has created a valid expectation in those parties affected that they can reasonably rely on the entity to undertake the restructuring. One respondent noted that although restructuring announcements are not legally binding, it is

extremely rare for an entity to recall its decision because it damages the reputation of the company. Some respondents suggested that the proposed amendments would not have the desired effect because entities would conclude that a constructive obligation to restructure existed and therefore would continue to recognise a single liability for all of the restructuring costs.

Although a decision to restructure might not create an obligation, an announcement of that decision might do so, if one applied the definition of a constructive obligation. For example, a liability might arise when an entity announces a restructuring plan if that announcement indicated to other parties it will accept particular responsibilities, and as a result of that announcement, the entity has created a valid expectation in those parties that they can reasonably rely on to discharge those responsibilities. However, the discussion of restructuring provisions in the Exposure Draft, together with the basis for conclusions, implies that a formal announcement never results in a constructive obligation. [CL 84]

Staff evaluation and recommendations

- 22 These respondents argue that a public announcement may make it very difficult for the management of an entity to abandon a restructuring plan, so that effectively the entity has little, if any, discretion not to go ahead with it.
- 23 However, the counter argument is that such commercial pressures do not amount to *obligations to the parties affected* by the restructuring. An entity has a present obligation only if it is obliged to another party who will benefit from the entity's performance of that obligation or suffer harm from its non-performance. For example, an obligation for employee or lease termination costs arises only if the entity is obliged to an employee or lessor. It is possible that commentators who think that a general announcement creates a constructive obligation have overlooked this link.
- 24 The way that constructive obligations were discussed in the Exposure Draft may have contributed to the commentator's misunderstanding. Paragraph 10 of the Exposure Draft carried forward (with only minor

amendments) the definition of a constructive obligation from the existing IAS 37:

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

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities; and
- (b) as a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.

25 Only later, in paragraph 15, did the Exposure Draft clarify that 'those other parties' are not any parties who know of the statement but the specific parties who will benefit from the entity's performance of the obligation or suffer from its non-performance. Those (like the commentator quoted in paragraph 21) who read only the definition and not the clarifying text could be misled.

26 The staff think that the Board has already taken significant steps toward eliminating the potential for confusion. During the first half of 2007, the Board redeliberated the defining features of liabilities—in particular the features that distinguished obligations (including constructive obligations) from business risks. As a result of these redeliberations, it tentatively decided, among other things:

- (a) to state that an entity has an obligation only if it 'has a duty or responsibility' to act or perform in a particular way.¹ The notion of a duty or responsibility (rather than of the entity having 'little, if any, discretion') should help to explain why the commercial pressure to undertake a restructuring once it has been announced is not necessarily an obligation.

¹ Among the conclusions summarised in paragraph 14 Agenda Paper 10A for the July 2007 meeting. The staff had proposed 'is bound' in the paper but, as reported in *Update*, the Board favoured 'has a duty or responsibility', which are the words used in the *Framework*.

- (b) to emphasise more strongly that the obligation must be to another party, who as a result can rely on the entity to act or perform in a particular way.²
- (c) to merge the definition of a constructive obligation into the guidance on when a present obligation exists.³ This change ensures that anybody referring to the description of a constructive obligation will see all of the criteria, not just those previously in the definition. The merged text would be something like:

15 In the absence of legal enforceability, particular care is required in determining whether another party can rely on the entity to act or perform in a particular way. ~~an entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this~~ This will be the case only if:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to the other party ~~parties~~ that it will accept particular responsibilities;
- (b) as a result the entity has created a valid expectation in that party ~~the other parties~~ that it can reasonably rely on ~~expect~~ the entity to perform those responsibilities; and
- (d) the other party ~~parties~~ will either benefit from the entity's performance or suffer harm from its non-performance.

27 The application guidance for restructurings (paragraph 62 of the Exposure Draft) needs to be updated to reflect these tentative decisions.

² Among the conclusions summarised in paragraph 14 of Agenda Paper 10A for the July 2007 meeting. The paper refers to the other party being able to 'call upon' the entity to act in a particular way. The change to 'rely on' was proposed in later discussions to make the general guidance for obligations consistent with the terminology used to describe constructive obligations.

³ July 2007, Agenda Paper 10C.

28 The staff suggest the following wording for consideration by the Board:

62 ~~A liability involves a present obligation to others that leaves the entity with little, if any, discretion to avoid settling the obligation.— An obligation exists if an entity has a duty or responsibility to act or perform in a particular way, and that duty or responsibility is owed to others who will benefit from the entity’s performance or suffer harm from its non-performance.~~ A decision by the management of an entity to undertake a restructuring does not give rise to such a duty or responsibility. It does not create a present obligation to others for costs expected to be incurred during the restructuring. ~~Accordingly, a decision by the management of an entity to undertake a restructuring is not the requisite past event for the recognition of a liability.—~~ A cost associated with a restructuring is recognised as a liability on the same basis as if that cost arose independently of the restructuring. Paragraphs 63-65 provide additional guidance for applying the definition of a liability to specified costs that are often associated with a restructuring.

29 On the basis of the above analysis, the staff recommend that the Board:

- (a) confirm the requirements for restructuring costs proposed in the Exposure Draft; but
- (b) update the application guidance along the lines of the text proposed in paragraph 28.

Questions for the Board

Do you agree?