IFRS

**IASB Meeting** | Agenda reference **7 (Appendix B)**

Staff Paper | Date **September 2010**

Project **Liabilities—IFRS to replace IAS 37**

Topic

# What's wrong with IAS 37?

## Purpose of this appendix

The table below summarises weaknesses in IAS 37 and the way in which a new IFRS would address the weaknesses, based on the Board's tentative decisions to date.

Thereafter, the appendix discusses each matter in more detail—explaining both the source of the weakness and the problems it creates in practice.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

## Summary of weaknesses in IAS 37

| Section | Weakness | Effect of tentative decisions |
|---|---|---|
| **1** | **Liability definition** | |
| **1.1** | **Constructive obligations**<br>• contradictory requirements and guidance make it difficult to judge whether an entity has a 'constructive' obligation and result in divergent practices.<br>• requirements for restructuring costs are inconsistent with the underlying principles and US GAAP. | Remove contradictions:<br>• replace notion of 'no realistic alternative' with notion of 'duty or responsibility to another party'.<br>• use this notion to explain that economic compulsion is not enough to create an obligation.<br>• illustrate the point by incorporating consensus of IFRIC 6.<br>• align requirements for restructuring costs with underlying principles and US GAAP. |
| **1.2** | **Future events**<br>IAS 37 does not give clear guidance on how future events affect the decision about whether an entity has a 'present' obligation. In particular, it fails to differentiate future events that affect the *existence* of a liability from those that affect the *outcome* of a liability. It lacks the clear guidance now in US accounting literature. | Use guidance developed in US accounting literature to clarify that:<br>• a *present* obligation must *exist* independently of any future events (though its outcome could depend on future events).<br>• thus, an obligation that will come into existence if a future event occurs (eg an obligation to make a payment if a triggering event occurs) is *not* a present obligation.<br>• however, such potential future obligations often have associated with them an *unconditional* present obligation (eg. to stand ready to make a payment). |
| **1.3** | **Contingent liabilities**<br>IAS 37 defines three types of item as 'contingent liabilities'. Only one meets the US GAAP definition of a contingent liability. IAS 37 (and other IFRS) requirements for contingent liabilities are sometimes applied to too narrow a group of items. | Delete label and instead describe separately (and specify separate requirements for) the items that the label encompasses. |

| Section | Weakness | Effect of tentative decisions |
|---|---|---|
| **2** | **Recognition** | |
| | **Probable outflows recognition criterion**<br>Liabilities are recognised only if outflows are probable. The 'probable outflows' criterion is not present in other IFRSs, such as IAS 39, and it:<br>• results in loss of information—some liabilities (such as guarantees) are 'off balance sheet', and hence not measured.<br>• diverts attention from the requirement to judge whether a liability exists, resulting in divergent practices. | Remove the 'probable outflows' recognition criterion.<br>Entities would then recognise all liabilities that can be measured reliably. Expectations about the range of possible outcomes and their associated probabilities would be taken into account in the measurement. |
| **3** | **Measurement** | |
| **3.1** | **Best estimate**<br>It is unclear what the 'best estimate' of a single obligation is. Views diverge. Often entities measure liabilities at the most likely outcome, ignoring other possible outcomes. | State explicitly that all obligations should be measured using 'expected value', ie the mean (probability-weighted average) of all possible outcomes. |
| **3.2** | **Future outflows**<br>IAS 37 does not specify the costs that an entity should include in the measurement of liabilities to perform services. Entities vary in the extent to which they include direct costs, indirect costs and margins. | Specify that an entity should include all these amounts. Where a market exists for the service, the entity should use the market (contractor) price. |
| **3.3** | **Other**<br>There is insufficient guidance on discount rates. In particular, it is unclear whether the rates should include non-performance risk. The result is material differences in liability measurements: | Responses to 2010 exposure draft request further guidance on non-performance risk. Staff will raise this matter for Board discussion in due course. |

| Section | Weakness | Effect of tentative decisions |
|---|---|---|
| **4** | **Other** | |
| **4.1** | **Reimbursement rights**<br>The recognition threshold for reimbursement rights (virtually certain) is higher than that for the associated liabilities. Therefore, entities have to recognise fluctuations in the value of liabilities (such as guarantees), but cannot always recognise the compensating fluctuations in the values of associated reimbursement rights. | Align the recognition criteria and measurement requirements for reimbursement rights with those for the associated liabilities. |
| **4.2** | **Contingent assets**<br>Some people interpret guidance on recognising contingent assets in a way that contradicts the general requirements of IAS 10 *Events after the Reporting Period*. As a consequence, they treat the settlement of a court case as a 'non-adjusting' event for the plaintiff, even though they treat it as an 'adjusting' event for the defendant. | Remove existing requirements and guidance. (Responses to 2010 exposure draft request further guidance. Staff will raise this matter for Board discussion in due course.) |
| **4.3** | **Onerous contracts**<br>IAS 37 gives little guidance on identifying and measuring onerous contracts. Constituents have identified a number of matters that they think lead to divergence in practice. | More guidance is proposed on some of the matters raised by constituents.<br>(Responses to 2010 exposure draft request further guidance. Staff will raise this matter for Board discussion in due course.) |

# FURTHER EXPLANATION OF WEAKNESSES SUMMARISED ABOVE

## 1 Guidance on identifying liabilities

### *1.1 Constructive obligations*

*The weakness in IAS 37*

1. The IASB *Framework* defines a liability as a 'present obligation ... arising from past events...'. IAS 37 provides guidance on the meaning of 'obligation'. It states that an obligation exists independently of the entity's future actions. (In other words, an entity does not have an obligation for any expenditure that it could avoid by its future actions.)

2. This statement is unambiguous. However, it is contradicted, or at least diluted, by two other aspects of the guidance:
   (a) a statement that the obligating event is the event that leaves the entity with no 'realistic' alternative to settling the obligation; and
   (b) a conclusion that once an entity has announced or started to implement a restructuring plan, it has a constructive obligation for the expected future costs of completing the restructuring. The basis for this conclusion is that announcing or starting to implement a plan raises valid expectations in other parties that the entity will complete it. Therefore, the entity has no realistic alternative to incurring the costs to complete the plan (even though it *could* avoid the costs by recalling or amending its plans).

3. The phrase 'no realistic alternative' does not derive from the IASB *Framework*. The IASB *Framework* instead describes an obligation as a 'duty or responsibility' to act or perform in a particular way.

*Resulting practical problems*

4. Preparers and their advisers sometimes find it difficult to judge whether an entity has 'no realistic alternative' to settling an obligation. For example, difficulties arise if entities could avoid future costs only by taking actions that might damage their own economic interests. Are such actions 'realistic alternatives'?

5. The IFRS Interpretations Committee addressed one such situation in IFRIC 6 *Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*. The Committee considered a view that an entity operating in a specific market has a constructive obligation for costs it will inevitably incur if it continues to operate in the market—withdrawing from the market is not a realistic alternative. However, it rejected the view, focusing instead on the statement in IAS 37 that an obligation must exist independently of the entity's future actions.

6. The IAS 37 requirements for restructuring costs not only contradict (and hence undermine) the principle that an obligation must exist independently of the entity's future actions. They also create a difference between IFRSs and US GAAP. Applying US GAAP, entities do not necessarily recognise the costs of a exit or disposal plan when they announce the plan. Instead they recognise each individual cost when they incur an obligation for that cost. The rationale is that an exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan.[1]

[1] FASB ASC Subtopic 420-10-25-2.

*Proposed solution*

7. The Board intends to make five changes that in combination would clarify the principles, eliminate the contradictions in the guidance and eliminate the difference between IAS 37 and US GAAP. The five changes involve:

   (a) deleting the notion of 'no realistic alternative'.

   (b) instead describing an obligation using the *Framework* notion of a 'duty or responsibility' to another party.

   (c) using this notion to explain that economic compulsion is *not* enough to create an obligation—an entity may be economically compelled to act in its own economic interests, but this does not mean it has a duty or responsibility to others to do so.

   (d) illustrating the point by incorporating the facts and conclusions of IFRIC 6 into the illustrative examples.

   (e) changing the requirements for restructuring costs, aligning them with US GAAP. Entities would recognise each individual cost at the same time as they recognise that cost if it arises independently of a restructuring.

### *1.2 Impact of future events*

*Weakness in IAS 37*

8. IAS 37 defines liabilities as present obligations. It identifies warranties and guarantees as liabilities. However, it does not explain *why* warranties and guarantees—which are contingent on the occurrence or non-occurrence of *future* triggering events—are *present* obligations.

*Proposed improvements*

9. Soon after IAS 37 was published, the US Financial Accounting Standards Board (FASB) articulated a rationale for treating guarantees as liabilities rather than loss contingencies. The rationale is that the issue of a guarantee obligates the issuer in two ways. It gives rise to:

   (a) a contingent obligation to make a payment if the specified triggering event occurs; and

   (b) a non-contingent obligation to stand-ready to perform over the term of the guarantee if the triggering event occurs. This obligation is not conditional on future events. It exists as soon as the entity has issued the guarantee. In other words, it is a present obligation. [2]

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[2] ASC Subtopic 460-10-25

10. The Board intends to use these arguments to give clearer guidance in IAS 37 about the meaning of 'present' in present obligation. Specifically:

    (a) a *present* obligation must *exist* independently of any future events (though its outcome could depend on future events).

    (b) thus, an obligation that will come into existence if a future event occurs (eg an obligation to make a payment if a triggering event occurs) is *not* a present obligation. It is a potential future obligation.

    (c) however, such potential future obligations often have associated with them *unconditional* present obligations. For example, associated with a potential future obligation to make a payment under the terms of a guarantee is an unconditional present obligation to stand ready to honour the guarantee. The unconditional present obligation meets the definition of a liability. Its outcome depends on future events, but its existence does not.

*Practical benefits*

11. The addition of such guidance to IAS 37 would improve the standard in two ways:

    (a) it would explain more clearly how future events affect the identification of liabilities. The distinction between liabilities and business risks would be clearer, reducing the risk of divergent interpretations.

    (b) the additional guidance would allow people to describe more accurately the liabilities they identify. If they can describe the liability accurately, they can also more readily measure it. For example, it would be clearer why a guarantee would be measured taking into account the range of possible outcomes—the entity is measuring the obligation to stand ready to honour the guarantee (which implicitly requires an assessment of all possible future outcomes and their uncertainty) not a potential future obligation to make a payment (which might cause the entity to focus more on predicting the most likely outcome).

### *1.3 Contingent liabilities*

*Weakness in IAS 37*

12. IAS 37 specifies three criteria that must be satisfied before an entity recognises a liability:

    (a) it must be probable that the entity has a present obligation;

    (b) it must be probable that the liability will result in a future outflow of economic benefits; and

    (c) the liability must be capable of being measured reliably.

13. If an obligation, or possible obligation, fails to satisfy *any one* of these three criteria, it is described as a ‘contingent liability’ and not recognised in the financial statements. The label ‘contingent liability’ thus provides a convenient shorthand for items that might be liabilities but for one reason or another are not recognised in the financial statements. However, the label is confusing for three reasons.

    (a) it is not accurate. It implies that the items it encompasses are not, or possibly are not, liabilities. However, those items that have failed only the second or third recognition tests are definite, known liabilities.

    (b) the label is often used in accounting literature with a different meaning. For example, in US accounting literature it is used to mean only situations in which it is uncertain whether a liability *exists*, and the uncertainty will be resolved only when future events occur.

    (c) even when used in the US GAAP sense, the term is open to misinterpretation. Some people have interpreted it as encompassing guarantees and similar obligations whose outcome (but not existence) is contingent on future events. The FASB has issued guidance explaining why such obligations are not contingent liabilities (see paragraph 9 above). However, this explanation is not in IAS 37 or orther IFRS literature.

*Resulting practical problems*

14. IAS 37 and several other IFRSs contain requirements for 'contingent liabilities'. However, because there is not a common understanding of the meaning of the term, people can be unclear about the range of items to which the requirements apply. Therefore, they apply the requirements inconsistently.

*Proposed solution*

15. The Board intends to delete the label 'contingent liability'. It intends to describe separately 'possible liabilities' and 'liabilities that cannot be measured reliably', and to prescribe specific requirements for each.

16. The Board has tentatively decided that the new IFRS would make consequential amendments to other IFRSs that contain requirements for contingent liabilities. In each IFRS, the reference to contingent liabilities would be deleted and replaced with a specific description of the items to which the requirements apply.

## 2 ‘Probable outflows’ recognition criterion

*Existing recognition criteria*

17. As noted in paragraph 12, IAS 37 specifies three criteria that must be satisfied before an entity recognises a liability:

    (a) it must be probable (more likely than not) that a liability exists, ie that the entity has a present obligation;

    (b) it must be probable (more likely than not) that the liability will result in a future outflow of economic benefits; and

    (c) the liability must be capable of being measured reliably.

18. The first criterion applies only if there is uncertainty about whether the entity has a present obligation—typically if an entity is defending a lawsuit or regulatory action. It might be uncertain:

    (a) whether a particular event occurred—ie whether the entity committed the act of wrong-doing for which it is being sued; or

    (b) how the law applies to that event—ie whether committing that act gives the entity an obligation to pay fines or compensation to the plaintiff.

19. The second criterion (the ‘probable outflows’ criterion) need be applied only if the entity has satisfied the first criterion, ie only if it is certain (eg in the case of a guarantee) or probable (eg in the case of a lawsuit) that the entity has a present obligation. The ‘probable outflows’ criterion prohibits recognition of liabilities that exist but are unlikely to require outflows in settlement. However, the criterion has less impact in practice than some might expect:

(a) the criterion typically has no impact for entities that have large populations of similar (but independent) obligations. IAS 37 requires entities to consider each population as a whole. Therefore, if is probable that even *some* of those obligations will result in an outflow, entities recognise liabilities for all the obligations in that population.

(b) the criterion has limited incremental impact for single liabilities arising from lawsuits and other asserted claims. Both the existence of an obligation and the need for future outflows depend on the same factor (whether the entity committed the act of wrong-doing) and will be confirmed by the same future event, ie the final court ruling. In other words, normally a lawsuit will satisfy either both of the first two criteria, or neither of them.

*Problems with the 'probable outflows' criterion*

20. The 'probable outflows' criterion is specified as a criterion for recognising liabilities in the IASB *Framework*. However:

(a) the criterion causes some liabilities to be 'off balance sheet'. Although these liabilities must be disclosed, they need not be measured. Investors are therefore deprived of information that would allow them to more readily compare entities.

(b) as explained in paragraph 19(b) above, the first and second recognition criteria have a similar effect when applied to liabilities arising from lawsuits. Possibly for this reason, some preparers and auditors applying IAS 37 by-pass the first criterion (is it probable that a liability exists?) and focus solely on the second (is an outflow probable?). This has led to a divergence in practice for situations in which management thinks that an entity does *not* have a liability to a claimant but intends to offer an out-of-court settlement anyway. Entities that apply only the second criterion recognise a liability for the likely out-of-court settlement, whereas those that also apply the first criterion do not.

(c) the 'probable outflows' criterion is not applied in other IFRSs, such as IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore, some liabilities (such as guarantees) might be 'on balance sheet' if within the scope of IAS 39, but 'off balance sheet' if they are within the scope of IAS 37. IAS 37 overcomes the problem for large populations of similar obligations by requiring entities to apply the criterion to the population as a whole. However, it does not overcome the problem for entities that have smaller numbers of (sometimes significant) statutory guarantee obligations.

*Proposed solution*

21. The Board intends to remove the 'probable outflows' recognition criterion from IAS 37. An entity would therefore recognise liabilities whenever:

(a) the available evidence suggests that the entity has a present obligation (existing criterion 1); and

(b) the entity can measure the liability reliably (existing criterion 3)

# 3 Measurement requirements

## 3.1 Best estimate

*The weakness in IAS 37*

22. IAS 37 requires entities to measure liabilities at the 'best estimate' of the expenditure required to settle the present obligation. It defines the 'best estimate' as 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'.

23. It could be argued that this amount necessarily takes into account all possible outcomes. And IAS 37 is clear that entities should measure large populations of liabilities using the weighted average of the possible outcomes, ie 'expected value'. However, IAS 37 is less clear about how an entity should measure single obligations. Paragraph 40 states that:

> 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.

24. This paragraph could be interpreted as an acknowledgement that, in some circumstances, simplifying assumptions can be used when estimating expected values. Thus, if the range of possible outcomes is a 'normal distribution' (such that the possible outcomes are evenly distributed about the most likely outcome), the most likely outcome is a reasonable approximation to expected value.

25. However, if this was the intention, it has not been stated sufficiently clearly. The analysis of the comment letters on the exposure draft that preceded IAS 37 forewarned that practices would diverge:

> A clear majority support the proposals set out in [the measurement section of E59]. But then [the first paragraph of that section] does not specify the measurement attribute, therefore a number of commentators seem to see their favourite measure accommodated and agree with that. Some commentators call for a clear measurement objective …[3]

26. And in practice, people do now interpret the meaning of best estimate in different ways. The accounting manuals of four large accounting firms give four different opinions on measuring the best estimate of a single obligation. They variously advise that:

    (a) the appropriate method will depend on the circumstances. The most likely outcome, or the maximum or minimum amount in the range of possible outcomes may be more appropriate than expected value.

    (b) the best estimate of a single obligation is usually the most likely outcome (an example is given to illustrate that this would be the case even if the other outcomes were all lower). Policies of measuring liabilities at the minimum or maximum amounts in the range of possible outcomes are not acceptable.

    (c) the best estimate of a single obligation is generally the possible outcome that is nearest to expected value. However, expected value itself is not a valid measurement.

    (d) the requirement sounds like a 'vague leaning' towards an expected value approach.

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[3] IASC Board meeting, January 1998, Agenda Paper 3A, *Analyis of comment letters on E59*, paragraph 12.

27. Any of the approaches that take into account only one possible outcome fail to distinguish between liabilities with very different mean outcomes. They do not measure the amount that the entity would rationally pay today to be relieved of the liability and all the uncertainties surrounding it.

*The proposed solution*

28. The Board proposes to require all liabilities to be measured using expected values.

### *3.2 Future outflows*

*The weakness and resulting practical problems*

29. IAS 37 does not specify the types of costs that entities should take into account when measuring the amount they would pay to settle or transfer an obligation. Entities include at least the incremental costs of materials and services. However, practices vary regarding the extent to which they also include:

    (a) other direct costs (eg an allocation of benefits paid to employees who will be directly involved in providing the service);

    (b) indirect costs (eg an allocation of other employee costs); and

    (c) any additional profit that an entity would charge to fulfil the obligation for another party (eg to decommission another entity's assets).

30. The Board has received requests for interpretative guidance on this matter.

*Proposed solution*

31. The latest exposure draft proposed that an entity should measure an obligation to perform a service at the price a contractor would charge to perform the service. This amount implicitly includes all items listed in paragraph 29.

## 4 Other problems

### *4.1 Reimbursement rights.*

32. Entities sometimes have rights to be reimbursed for costs of fulfilling obligations within the scope of IAS 37 At present, IAS 37 permits entities to recognise assets for reimbursement rights only if is 'virtually certain' that the entity will receive reimbursement if the entity fulfills the obligation. The difference between this recognition threshold and the more-likely-than-not threshold for associated liabilities can lead to distortions. Entities have to recognise fluctuations in the value of liabilities, but cannot always recognise the compensating fluctuations in the values of the reimbursement rights, if there is any doubt about the existence of the right or the ability of the counterparty to pay.

33. The Board intends to align the recognition criteria for reimbursement rights with the criteria for the liabilities that they reimburse.

### *4.2 Contingent assets*

34. IAS 37 defines contingent assets as possible assets, whose existence will be confirmed by uncertain future events. A plaintiff in a lawsuit has a contingent asset. Some people interpret IAS 37 guidance on recognising contingent assets as contradicting (and overriding) the general requirements of IAS 10 *Events after the Reporting Period*. As a consequence, they treat the settlement of a court case as a 'non-adjusting' event for the plaintiff, even though they treat it as an 'adjusting' event for the defendant.

35. The Board intends to delete the existing recognition requirements and guidance for contingent assets. (A possible need for new requirements to replace those lost has been identified in responses to the 2010 exposure draft. The staff will ask the Board to consider this matter in due course.)

#### *4.3 Onerous contracts*

36. Onerous contracts (contracts in which the unavoidable costs exceed the economic benefits) are within the scope of IAS 37. However, IAS 37 gives little guidance on identifying and measuring onerous contracts. Constituents have suggested that, as a result, practices diverge on matters such as:

    (a) the timing of recognition of liabilities for contracts that will become onerous only as a result of an entity's own actions;

    (b) measurement of an onerous purchase contract if the entity does not intend to use the purchased asset in its highest and best use; and

    (c) identifying onerous contracts:

        (i) whether the comparison of costs and benefits should apply to the whole contract, parts within a contract or the unsatisfied portion of the contract,

        (ii) which costs should be included, and

        (iii) whether the benefits are only those specified in the contract, or could include indirect benefits such as access to further contracts.

37. The Board intends to add guidance to address the first and second of these matters. (A possible need for more guidance on the third matter—identifying onerous contracts—been identified in responses to the 2010 exposure draft. The staff will ask the Board to consider this matter in due course.)