STAFF PAPER

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Project	**Provisions and contingent liabilities (IAS 37)**	
Paper topic	Case studies	
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Introduction

This paper contains two case studies for discussion in break-out sessions.

The case studies provide a focus for discussion of the issues described in Agenda Paper 3A.

- Case Study 1 describes a reporting entity with a liability to fulfil another party's obligations if that other party defaults. The probability of default gradually increases as circumstances change. You are asked to discuss when recognition of the liability in the reporting entity's statement of financial position would provide useful information, and whether the benefits of recognising the liability at that time would exceed the costs.
- Case Study 2 describes an entity that is facing a court case with a range of possible outcomes. You are asked to discuss which amount within the range is the most useful measure of the entity's liability, and whether estimating that amount is practicable.

Information about the Capital Markets Advisory Committee (CMAC) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/CMAC/Pages/CMAC.aspx

Information about the Global Preparers Forum (GPF) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/Pages/Global-preparers-forum.aspx

1 Case Study 1—recognition thresholds

Fact pattern

The reporting entity, an oil and gas producer, sells a group of its oil and gas installations to another producer in Year 1. The regulatory environment is such that:

(a) the new owner also takes on the regulatory obligation to decommission the installations at the end of their useful lives, and acquires the fund that the reporting entity had started to build to cover the decommissioning costs.

(b) the reporting entity retains a regulatory obligation to stand ready contribute to the decommissioning costs if and to the extent that the new owner defaults on its obligations.

Years 1-3

In the first three years after the transaction, management of the reporting entity judges the risk of default by the new owner to be remote. Accordingly, applying IAS 37, the reporting entity neither recognises a provision in its statement of financial position nor discloses the contingent liability.

Years 4-7

In Year 4, the first signs emerge that the possibility of default by the new owner is no longer remote: the new owner has reduced its annual contribution to the decommissioning fund (though indicating that it expects to be able to make up the contributions in later years). The balance on the decommissioning fund is still 150 million currency units lower than the estimated costs.

Management of the reporting entity monitors the new owner's financial position closely through Years 4-7. Management gradually revises upwards its estimates of the likelihood of the new owner defaulting, and of the amount that the reporting entity may have to contribute if default occurs. However, throughout that period management continues to estimate that the probability of having to make *any* contribution remains below 50%.

Accordingly, applying IAS 37, the reporting entity discloses its contingent liability, but does not recognise a provision in its statement of financial position. It discloses a brief description of the nature of the contingent liability, an estimate of the financial effect and an indication of the uncertainties relating to the amount or timing of any outflows.

Year 8

During Year 8, the financial position of the new owner deteriorates sharply. At the end of Year 8, management of the reporting entity estimates that it is probable that the new owner will default on its obligations and that the regulator will start proceedings against the reporting entity to recover a shortfall of 100 million currency units on the decommissioning fund.

Applying IAS 37, the reporting entity recognises a provision at the end of the year. It also discloses a brief description of the nature of its liability, the expected timing of any resulting outflows and an indication of the uncertainties about the amount or timing of those outflows.

Questions for discussion

Questions primarily for CMAC members

1.1 From Year 1, the reporting entity has a liability to stand ready to contribute to the new owner's decommissioning costs. At what point do you think recognition of a provision in the statement of financial position would provide investors with useful information about the reporting entity's financial position, or about changes in its financial position from one year to the next?

1.2 Which measure of the liability at that time would provide the most useful information about the liability? Should the liability be measured at an estimate of the amount that the reporting entity would be required to pay *if* the new owner defaulted, or should that amount be reduced to take into account the possibility that there will be no default?

1.3 Have you encountered in practice any liabilities that do not satisfy existing IAS 37 recognition criteria but whose recognition would provide you with useful information?

1.4 Thinking about the IAS 37 recognition criteria more generally (ie all the criteria listed in paragraph 14 of Agenda Paper 3A): do you think the thresholds are too high, too low, or about right? If not about right, how would you change the thresholds and what benefits do you think the changes would achieve?

Questions primarily for GPF members – see next page…

Questions primarily for GPF members

1.5 Do you think the CMAC members' suggestions would be practicable for preparers of financial statements, or do you think the costs would exceed the benefits?

1.6 Thinking about the IAS 37 recognition criteria more generally (ie all the criteria listed in paragraph 14 of Agenda Paper 3A), do you think the thresholds are too high, too low or about right? If not about right, what problems do the existing thresholds give you, how would you change them, and what benefits do you think the changes would achieve?

2 Case Study 2—measurement

Fact pattern

An entity is being sued for damages, with the plaintiff claiming 150 million currency units (CU). On the basis of the available evidence, and having considered expert opinions, management judge that it is probable (but by no means certain) that the courts will rule in favour of the plaintiff, but if so would award no more than CU100 million to the plaintiff.

The entity has already offered CU30 million to settle the claim immediately. Its offer has been rejected, but management are willing to increase the offer to CU50 million and think that there is a reasonable possibility that this higher offer will be accepted.

If the higher offer is not accepted, management will continue to consider ways of defending the claim. It thinks that there is a reasonable possibility that it could settle out of court later in the proceedings, probably for about CU70 million. However, there is also a reasonable possibility that the plaintiff will take the claim through the courts.

Management assigns approximate probabilities to the outcomes it has identified:

Outcome		Estimated cash flows (CU)	Estimated probability
Early out-of-court settlement		50 million	35%
Later out-of-court settlement		70 million	25%
Court decision	Win	0	10%
	Lose	100 million	30%

Notes

Most likely outcome

For any distribution of outcomes, the outcome identified as the most likely one depends on the number and width of the bands into which the range is divided. In this example, management have identified four outcomes, with early settlement at CU50 million being the most likely outcome of the four.

(Management could have identified fewer or more separate outcomes. For example, they could have identified more than two different settlement outcomes. In that case, management might identify losing in court as the individually most likely outcome.)

Expected value

The expected value (probability-weighted average, arithmetic mean) of the possible outcomes is CU65 million.[1]

Median outcome (maximum amount that the entity is more likely than not to pay)

The median point of the distribution is CU70 million. At the median point of a distribution, there is no more than a 50% chance of a higher outflow, and no more than a 50% chance of a lower outflow. The median outcome equals the maximum amount that the entity is more likely than not to pay.[2]

Questions for discussion

Questions for all participants

2.1 To recognise a liability, the entity must pick a single amount within the range of possible outcomes as the basis for measuring it. Do you think that specifying a particular measure or measures in IAS 37 (eg most likely outcome, expected value, median or some other amount) would improve comparability?

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[1] (CU50 x 35%) + (CU70 x 25%) + (CU100 x 30%).

[2] The probability of the entity paying at least CU70 million is 25% + 30% = 55%, ie more likely than not. The probability of the entity paying more than CU70 million is only 30%.

Questions primarily for CMAC members

2.2 For the facts in this case study, which amount do you think would provide the most relevant information about, and faithful representation of, the liability and expense (and of any changes in the liability and expense from one period to the next)? Why?

2.3 If you think that the individually most likely outcome provides the most relevant information and faithful representation, would you wish the IASB to standardise the method of banding outcomes? If so, can you suggest how it should standardise them?

2.4 Would you favour a different measure if the liability had a different distribution of possible outcomes eg if the outcomes were binary or concentrated on one value? If so, what types of distribution do you have in mind and what measure would you favour for those distributions?

Questions primarily for GPF members

2.5 Would the CMAC members' suggestions be practicable for preparers of financial statements?

2.6 If not, how would you amend them to make them more practicable?