Comments on behalf of The Association of Corporate Treasurers on:

Exposure draft of proposed amendments to IAS 37 provisions, contingent liabilities and contingent assets and IAS 19 Employee Benefits (June 2005)

An exposure draft from the International Accounting Standards Board

Introduction

The Association of Corporate Treasurers (ACT)

Established in the UK in 1979, The Association of Corporate Treasurers is a centre of excellence for professionals in treasury, including risk and corporate finance, operating in the international marketplace. It has over 3,500 members from both the corporate and financial sectors, and its membership, working in companies of all sizes, includes representatives from 95 of the FTSE 100 companies.

The ACT has 1,500 students in more than 40 countries. Its examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading provider of professional treasury education. The ACT promotes study and best practice in finance and treasury management. It represents the interests of non-financial sector corporations in financial markets to governments, regulators, standards setters and trade bodies.

Contact details are provided on the last page of these comments.

This consultation

These comments are on the record and may be freely quoted.

General Comments: IAS 37 provisions, contingent liabilities and contingent assets

We accept that a theoretical case can be made for the approach considered in the consultation paper.

However, the ACT believes that the principles in the current IAS are not so wrong as to warrant any change. The new approach would appear to be taking a more formal rules based stance rather than the traditional IFRS principles based approach. This change of direction is regrettable given that a principles based approach allows more flexibility to produce a result

which is more relevant and certainly conveys more meaningful information to the user of the accounts.

The new approach to conditional events leads onto the need to assess the open market value of the present obligations measured on the basis of expectation. At this point the strict formality of the rule based, legal analysis approach breaks down and we enter the realm of probability and supposition. The degree of subjectivity in assessing the measure of the liability makes a nonsense of any rationale for taking a strict legal approach. Where an item or amount is very uncertain the question is whether it is better to recognise nothing rather than using probabilities to recognise some proportion of the maximum potential amount?

In practical terms the exposure draft is proposing that the accounts recognise something that is by definition likely to be somewhat arbitrary and inevitably will be the wrong amount and could be wrong by an order of magnitude. A legal claim for £10m which has a probability of success of 20% would give a valuation (in crude terms) of £2m, whereas in reality the possible outcomes are likely to be either nil or the full £10m and the most probable outcome is nil (as discussed in BC81). There is also the possibility that the matter will be settled at some intermediate amount to avoid the uncertainties of litigation.

Where there is a substantial degree of uncertainly we believe the current standard requiring disclosure of the estimated financial effect and the uncertainties surrounding it is a perfectly good way of alerting the reader to the possibility of contingencies, but without distorting the results for that one off possibility.

The existing standard does itself already require an estimate of probability in that once the contingency is more likely than not it should be provided for, but this is not attempting a high degree of precision as is implied to be needed under the exposure draft.

In looking at any new proposal it is instructive to go back to the IASB Framework and to cross check against the core qualitative characteristics of financial statements. The use of probability accounting based on expected values does not sit easily with the following three attributes that make information useful to users.

> **Reliability:** "To be useful information must be reliable……free from material error and bias……Information may be relevant but so unreliable in nature or representation that its recognition is potentially misleading."
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> **Faithful Representation:** "To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria."
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> "Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be

> measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; ……………In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement."
>
> **Substance Over Form:** "If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form."

By and large we note that the new proposals will result in amounts being recognised for contingent liabilities somewhat earlier that is currently the case. Comparing this with the proposals for IAS 19 and employee benefits, the proposals there will tend to mean that reporting entities will end up being less prudent than they are at present. There seems to be an inconsistency in seeking more prudence in one place and less in the other.

Specific Questions: IAS 37 provisions, contingent liabilities and contingent assets

Question 1 – Scope of IAS 37 and terminology

The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To emphasise this point, the Exposure Draft does not use 'provision' as a defined term to describe liabilities within its scope. Instead, it uses the term 'non-financial liability' (see paragraph 10). However, the Exposure Draft explains that an entity may describe some classes of non-financial liabilities as provisions in their financial statements (see paragraph 9).

(a) Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why?

(b) Do you agree with not using 'provision' as a defined term? If not, why not?

Answer 1: See general comments above. Given that we do not see any convincing need to change the existing IAS 27, we see no particular need to remove 'provision' as a defined term.

Question 2 – Contingent liabilities

The Exposure Draft proposes to eliminate the term 'contingent liability'. The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations (see paragraph BC11). Hence, it highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or

conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30).

The Basis for Conclusions also explains that many items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because the contingency does not relate to whether an unconditional obligation exists. Rather it relates to one or more uncertain future events that affect the amount that will be required to settle the unconditional obligation (see paragraph BC23).

The Basis for Conclusions highlights that many items previously described as contingent liabilities can be analysed into two obligations: an unconditional obligation and a conditional obligation. The unconditional obligation establishes the liability and the conditional obligation affects the amount that will be required to settle the liability (see paragraph BC24).

The Exposure Draft proposes that when the amount that will be required to settle a liability (unconditional obligation) is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events, the liability is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur). Uncertainty about the future event(s) is reflected in the measurement of the liability recognised (see paragraph 23).

(a) Do you agree with eliminating the term ‘contingent liability’? If not, why not?

(b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

Answer 2: We do not agree with eliminating the term contingent liability and moving to the unconditional obligation plus probability approach mentioned. Please see the general comments above.

Question 3 – Contingent assets

The Exposure Draft proposes to eliminate the term ‘contingent asset’.

As with contingent liabilities, the Basis for Conclusions explains that assets arise only from unconditional (or non-contingent) rights (see paragraph BC11). Hence, an asset (an unconditional right) cannot be contingent or conditional, and a right that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to an asset (see paragraph BC17).

The Basis for Conclusions also explains that many items previously described as contingent assets satisfy the definition of an asset in the *Framework*. This is because the contingency does not relate to whether an unconditional right exists. Rather, it relates to one or more uncertain future events that affect the amount of the future economic benefits embodied in the asset (see paragraph BC17).

The Exposure Draft proposes that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38 *Intangible Assets* rather than IAS 37 (except for rights to reimbursement, which remain within the scope of IAS 37). This is because such items are non-monetary assets without physical substance and, subject to meeting the identifiability criterion in IAS 38, are intangible assets (see paragraph A22 in the Appendix). The Exposure Draft does not propose any amendments to the recognition requirements of IAS 38.

(a) Do you agree with eliminating the term ‘contingent asset’? If not, why not?

(b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?

Answer 3: To the extent that the proposals on contingent assets mirror the logic proposed for assessing contingent liabilities the same observations made under our general comments can be applied.

Question 4 – Constructive obligations

The Exposure Draft proposes amending the definition of a constructive obligation to emphasise that an entity has a constructive obligation only if its actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform (see paragraph 10). The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation (see paragraph 15).

(a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?

Answer 4a: The small change to the definition is helpful in clarifying it

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

Answer 4b: No comment

Question 5 – Probability recognition criterion

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognised unless they cannot be measured reliably.

The Basis for Conclusions emphasises that the probability recognition criterion is used in the *Framework* to determine whether it is probable that settlement of an item that has previously been determined to be a liability will require an outflow of economic benefits from the entity. In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. The Basis notes that in many cases, although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require *some* outflow of resources. An example is an entity that has an obligation to decommission plant or to restore previously contaminated land. The Basis also outlines the Board's conclusion that in cases previously described as contingent liabilities in which the entity has an unconditional obligation and a conditional obligation, the probability recognition criterion should be applied to the unconditional obligation (ie the liability) rather than the conditional obligation. So, for example, in the case of a product warranty, the question is not whether it is probable that the entity will be required to repair or replace the product. Rather, the question is whether the entity's *unconditional* obligation to provide warranty coverage for the duration of the warranty (ie to stand ready to honour warranty claims) will probably result in an outflow of economic benefits (see paragraphs BC37-BC41).

The Basis for Conclusions highlights that the *Framework* articulates the probability recognition criterion in terms of an outflow of economic benefits, not just direct cash flows. This includes the provision of services. An entity's unconditional obligation to stand ready to honour a conditional obligation if an uncertain future event occurs (or fails to occur) is a type of service obligation. Therefore, any liability that incorporates an unconditional obligation satisfies the probability recognition criterion. For example, the issuer of a product warranty has a certain (not just probable) outflow of economic benefits because

it is providing a service for the duration of the contract, ie it is standing ready to honour warranty claims (see paragraphs BC42-BC47).

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

Answer 5: We do not agree that the existing methodology and the concept of the probability recognition criterion is so wrong as to require the change proposed in the Exposure Draft. Under the existing standard a provision is only recognised when, inter alia, "it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation"

This approach would seem to be appropriate and to work adequately for most situations. For the big one off claims that are binary in nature (e.g. a major law suit) they are either provided for in whole or not at all. For multiple claims (such as warranty claims), often smaller in size, entities are able to take a view on expected outcomes because there will be a distribution of claims to which a statistical analysis can validly be applied. Each claim may be binary but in combination there will be an expected level of successful claims and based on this the entity will make a suitable provision.

The changes proposed to the standard would essentially not result in any change to the accounting for the multiple claims described above. However in the case of the one off major law suit a non financial liability would be recognised immediately at an amount based on probabilities. It is in examples like this that we feel the proposals present a misleading impression of the final outcome and give a spurious and quite unhelpful degree of accuracy to an uncertain outcome.

It is also possible that the warranty claims may take the form of a smaller number of major claims. For example the provider of major capital or construction projects may have its bank issue performance guarantees for substantial amounts. If none of these give rise to a probable outflow then a company would not provide under the existing standard, although if the number of performance bonds were to be large then the set up described in para 24 of the existing standard could apply and in combination an amount does become more likely than not.

Overall the existing probability recognition criteria would appear to allow a realistic degree of flexibility and adaptability in order to give a fair representation of circumstances where there is a significant degree of uncertainty. It is important to preserve this.

Question 6 – Measurement

The Exposure Draft proposes that an entity should measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date (see paragraph 29). The Exposure Draft explains that an expected cash flow approach is an appropriate basis for measuring a non-financial liability for both a class of similar obligations and a single obligation. It highlights that measuring a single obligation at the most likely outcome would not necessarily be consistent with the Standard's measurement objective (see paragraph 31).

Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why?

Answer 6: For the reasons already explained we do not believe that the measurement methodology based on probabilities can be applied to contingencies where the number of similar items is not large. The amount that a third party would pay, based on an expected cash flow approach will not automatically give an amount that is more likely than not to be paid out and is therefore potentially misleading.

Repeating the point mentioned in the general comments above: A legal claim for £10m which has a probability of success of 20% would give a valuation (in crude terms) of £2m, whereas in reality the possible outcomes are likely to be either nil or the full £10m and the most probable outcome is nil. A settlement at an intermediate sum is also possible to avoid the uncertainties of a trial.

There is a further point here over commercial confidentiality. The decision whether or not to provide for legal claims has always been sensitive commercially. The making of a provision could be regarded as tantamount to an admission of liability and thus materially weaken a firms negotiating position. Recognising claims based on an assessment of the probability will likewise mean disclosing the strength of a firm's defences in every single case and as such will lead to enormous conflicts for management in assessing the probabilities and amounts.

Where there are a number of similar obligations the measurement methodology proposed becomes more realistic (since the outcomes are more predictable in statistical terms) and does not disclose so clearly the management's view of any particular case and it is therefore acceptable.

Question 7 – Reimbursements

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).

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

Answer 7: The old standard required that the reimbursement is recognised only when it is virtually certain that reimbursement will be received. The exposure draft has removed this and inserted the necessary criterion that the reimbursement right can be measured reliably. Quite sensibly the exposure draft is applying the same logic to reimbursements as it does to recognising only unconditional obligations. Although not stated specifically it is assumed that the reliable measurement referred to will follow the methodology of new paras 29 to 34.

The same disquiet that we have already mentioned about recognising amounts based on expected cash flows rather than most probable flows will apply here too, unless the number of similar claims is large. This is an important point.

Question 8 – Onerous contracts

The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be recognised until the entity takes that action. Hence, in the case of a property held under an operating lease that becomes onerous as a result of the entity's actions (for example, as a result of a restructuring) the liability is recognised when the entity ceases to use the property (see paragraphs 55 and 57). In addition, the Exposure Draft proposes that, if the onerous contract is an operating lease, the unavoidable cost of the contract is the remaining lease commitment reduced by the estimated sublease rentals that the entity could reasonably obtain, regardless of whether the entity intends to enter into a sublease (see paragraph 58).

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

Answer 8a: To an extent this is a helpful clarification as to when a contract actually becomes onerous. However we would ask the Board whether they might consider going further and stating that the liability should be recognised when the entity has "taken the action *or decided to take the action*". This introduces the possibility of an entity applying an additional degree of prudence in accruing for an amount that it knows it will become liable for. Given that many of the other changes to IAS 37 have introduced the concept of accounting on the basis of expected cash flows it might be more logical to do the same here if the entity has decided to take the action but not yet done so one might interpret it as highly likely that they will take the action. Some audit discretion could be applied here so that if by the time of the accounts preparation no action has been taken based on an earlier decision, then one might presume that in fact that decision has been reversed, likewise a subsequent action would confirm the decision.

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

Answer 8b: No comment

(c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?

Answer 8c: No comment

Question 9 – Restructuring provisions

The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those costs (see paragraphs 61 and 62).

The Exposure Draft proposes guidance (or provides cross-references to other Standards) for applying this principle to two types of costs that are often associated with a restructuring: termination benefits and contract termination costs (see paragraphs 63 and 64).

(a) Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?

(b) Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?

Answer 9: Determining exactly when an entity has a liability can be a somewhat grey area, and it may be that the Framework concept of Substance over form should be applied. Indeed the current Framework description of a liability includes the idea of an obligation arising as a responsibility coming out of a desire to maintain good business relations. The Exposure draft moves towards a strict definition based on legal obligations and seems to be another example of IFRS turning into a set of Rules rather than the traditional principles, which allow for a degree of flexibility. We deprecate such a tendency.

The ACT does not believe that the changes proposed are either necessary or desirable. The concept of constructive obligations that is in the current IAS 37, we feel, will give a more realistic and understandable view of an entity's financial position. The criteria in IAS 37.75 require a degree of commitment to a restructuring before any liabilities are provided for and this is right. For example if any entity announces a restructuring plan as part of a defence to a takeover, even if no legal liability has arisen to carry it through it would be reputationally disastrous if they failed to fulfil that plan or at least the bulk of it. In any case, if the matter is material, announcing a project for which there is no real intent could be seen as an offence under securities law as it is in the UK and other EU jurisdictions.

General Comments: IAS 19 Employee Benefits

The accounting for termination benefits is not normally an area which falls within the remit of the corporate treasurer so The Association of Corporate Treasurers would not normally wish to comment on this Exposure Draft. However we note that the proposed approach to IAS 19 would appear inconsistent with that being proposed for IAS37 and therefore we make some limited comments below.

The proposals in the exposure draft appear to be moving towards a strictly legalistic approach rather than taking the substance over form. There seems to be less weight attached to management intent and rather more to the entity's actual legal liability. This could be characterised as moving from a principles based system towards a more rules based regime. Given that one of the recognised strengths of IFRS generally is that they depend largely on principles it is discouraging if this approach is being reversed.

Specific Questions: IAS 19 Employee Benefits

Question 1 – Definition of termination benefits

The Exposure Draft proposes amending the definition of termination benefits to clarify that benefits that are offered in exchange for an employee's decision to accept voluntary termination of employment are termination benefits only if they are offered for a short period (see paragraph 7). Other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits (see paragraph 135).

Do you agree with this amendment? If not, how would you characterise such benefits, and why?

Answer 1: The amended definitions are helpful in giving additional detail and guidance

Question 2 – Recognition of termination benefits

The Exposure Draft proposes that voluntary termination benefits should be recognised when employees accept the entity's offer of those benefits (see paragraph 137). It also proposes that involuntary termination benefits, with the exception of those provided in exchange for employees' future services, should be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria (see paragraph 138).

Is recognition of a liability for voluntary and involuntary termination benefits at these points appropriate? If not, when should they be recognised and why?

Answer 2: The proposals will generally have the effect that voluntary and involuntary termination benefits are not recognised as early as under the existing standard. The basis for this change probably does better reflect the legal obligations of the entity but this is not helpful. In our view it does not properly recognise the constructive obligation that can arise. In similar vein to our comments on the IAS37 Exposure Draft we feel that the substance over form argument is applicable in may circumstance surrounding termination plans and the current criteria recognise that and leave a degree of flexibility.

The new proposals in the IAS 19 Exposure Draft can be defended but we do not see that there is any compelling reason to change the current standard. Indeed there are strong advantages in staying with the present approach.

We would also like to point out an anomaly that the changes to IAS 37 being exposed at the same time have the effect of bringing more contingent type obligations onto the balance sheet based on expectations whereas in this IAS 19 exposure draft you could have the circumstance where there is a high degree of expectation that termination payments may be triggered or offered but these are not recognised until the full legally binding steps are taken. This is inconsistent and unhelpful to users of accounts.

Question 3 – Recognition of involuntary termination benefits that relate to future service

The Exposure Draft proposes that if involuntary termination benefits are provided in exchange for employees' future services, the liability for those benefits should be recognised over the period of the future service (see paragraph 139). The Exposure Draft proposes three criteria for determining whether involuntary termination benefits are provided in exchange for future services (see paragraph 140).

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

Answer 3: No comment

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