

Accounting alert

Analysis of the latest accounting developments delivered to you via e-mail

IASB Issues Exposure Draft of Amendments to IAS 37 and IAS 19

The exposure drafts are now freely available on the IASB and AASB web sites.

The International Accounting Standards Board has issued an exposure draft of amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*.

The AASB last week consequently issued ED 140 Proposed Amendments to AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 119 *Employee Benefits*.

The proposed amendments are a result of two of the IASB's current projects: Phase II of the Business Combinations project and the Short-term Convergence project with the Financial Accounting Standards Board.

This Accounting Alert provides an Australian perspective on some of the key proposals and their impacts.

Overview

The proposals significantly change the conceptual approach taken when considering provisions and contingencies.

The proposed amendments represent a wholesale change to the concept and recognition of liabilities. The proposals would remove the concepts of 'provisions' and 'contingent liabilities' and instead introduce the new concept of 'non-financial liabilities'.

Any unconditional obligation will be required to be measured and recognised, regardless of the likelihood of any payment being ultimately made, e.g. a 'non-financial liability' would be recognised even for a court case where directors believe that the case will be successfully defended. Conversely, the need for an unconditional obligation will result in less liabilities being recognised in areas such as restructurings. Similar, but less extensive, changes are proposed on the asset side with items previously considered 'contingent assets' now being treated in accordance with the normal rules for intangible assets.

There is a widespread possibility of major changes in reported net assets and profitability resulting from these changes. Most entities would be expected to have a raft of 'unconditional obligations' and this innocuous term should not lead to complacency: obligations can arise through many types of agreements and transactions and a key issue will be to identify these obligations.

Key considerations include:

- more 'soft' assets and liabilities being recognised on the balance sheet
- more volatility in reported profits – the recognised value of liabilities will change as uncertainties and probabilities change, generally resulting in movements in the profit and loss
- difficulties in measurement, particularly for items that would previously be considered 'contingent liabilities', e.g. how will companies measure the 'fair value' of a court case that has recently been filed against it?
- the introduction of a lot of subjectivity in the measurement of non-financial liabilities – presenting new uncertainties for directors and auditors
- whether systems and processes are needed to identify and quantify unconditional liabilities
- flow on impacts to items affected by the changes, such as banking covenants, key management remuneration arrangements, dividend planning and so on.

The proposals are in part of a 'consequential' amendment resulting from the joint IASB/FASB business combinations phase II proposals – the need for consistent treatment of liabilities became a key convergence issue. More information on the business combinations proposals can be found in *Accounting Alert 2005/10*.

Summary of Key Changes and Impacts		
Current AASB 137 requirement	ED 140 change	Consequences compared to current accounting
Disclose contingent liabilities that are possible obligations or are not recognised because it is not probable that an outflow of resources will be required to settle the obligation.	A non-financial liability is recognised for the unconditional (present) obligation and is measured taking into account any conditional (uncertain) obligation.	<ul style="list-style-type: none"> • more liabilities recognised on the balance sheet • some contingent liabilities previously recognised as part of a business combination will not qualify for recognition • current measurement models for provisions will need to be reconsidered.
Disclose contingent liabilities that are not recognised because they cannot be reliably measured.	Such liabilities are disclosed in the notes to the financial statements.	<ul style="list-style-type: none"> • no impact.
Provisions are recognised when an outflow of resources is probable.	Probability criterion removed. Any conditional component is considered in the measurement of a non-financial liability.	<p>The impact is dependent on individual circumstances. There may be:</p> <ul style="list-style-type: none"> • no impact • an increase in liabilities, or • a decrease in liabilities.
Measure provisions using the 'best estimate' of cash flows. Entities are permitted to use the individual most likely outcome as the 'best estimate' for a single obligation.	'Best estimate' measurement concept removed. Use an expected cash flow approach for all obligations where there is no directly observable market price.	<ul style="list-style-type: none"> • current measurement models for provisions will need to be reconsidered.
Disclose contingent assets.	Contingent assets recognised where they meet the definition of an asset.	<ul style="list-style-type: none"> • accounted for in accordance with AASB 138.
Recognise constructive obligations.	The actions of an entity must result in other parties having a valid expectation that they can reasonably rely on the entity to discharge its responsibilities.	<ul style="list-style-type: none"> • a liability is not recognised when the entity has discretion to avoid settling.
A restructuring provision is recognised as a liability at a specified point for all costs associated with the restructuring.	Liabilities for each cost associated with a restructuring are recognised when the liability for each cost is incurred.	<ul style="list-style-type: none"> • restructuring liabilities recognised at a later date • restructuring liabilities recognised over a longer time period • less restructuring liabilities recognised as part of a business combination.

Detail of Key Changes

Scope and terminology

ED 140 applies to all non-financial liabilities.

ED 140 applies to all non-financial liabilities. This scope is broader than the scope of the current version of AASB 137, which only applies to provisions, contingent liabilities and contingent assets. A non-financial liability is a much broader concept than a provision as it also includes liabilities that are not uncertain in timing or amount (not already covered by another Standard).

Non-financial liabilities are recognised when an unconditional obligation exists, i.e. when an entity has a present obligation.

The ED proposes to eliminate the term contingent liability.

Contingent liabilities

The ED proposes to eliminate the term 'contingent liability' and use the term 'conditional obligation' to refer to uncertainty about the amount that will be required to settle a non-financial liability. Uncertainty does not affect recognition of a non-financial liability.

For example, consider an entity defending a lawsuit. The entity has an unconditional (present) obligation to perform as directed by the court. The entity has a conditional (uncertain) obligation to pay any penalties imposed by the court.

- the unconditional obligation (i.e. the present obligation) is recognised as a non-financial liability.
- the conditional obligation (i.e. uncertainty about whether a penalty will be imposed by the court) is reflected in the measurement of the non-financial liability.

Probability criterion to be omitted from AASB 137.

Probability recognition criterion

The ED proposes to omit the probability criterion from the current version of AASB 137. As outlined above, a non-financial liability can only arise from an unconditional obligation and, by definition, the probability recognition criterion is always satisfied for an unconditional obligation.

Therefore, the probability criterion has been removed to avoid any misinterpretation of the use of the probability criterion (e.g. applying the probability criterion to the conditional obligation inappropriately).

Expected cash flow approach to be used to measure all obligations with no directly observable market.

Measurement

The ED proposes that a non-financial liability will be measured on a fair value basis. This is the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date. Although this requirement exists in the current version of AASB 137, it is more prominent in the ED due to the proposed deletion of the 'best estimate' measurement concept.

The ED also states that the most appropriate way to measure obligations for which there is no directly observable market price is to use an expected cash flow approach. This method is consistent with the current version of AASB 137 for large population items; however for single obligations the current version of AASB 137 specifies that 'the individual most likely outcome may be the best estimate'.

Example: Defending a lawsuit

Legal proceedings have commenced seeking damages from an entity. The entity is disputing liability. Up to the date of authorisation for issue of the financial statements for the year ended 31 December 20X8, the entity's lawyers advise that it is unlikely that they entity will be found liable.

The entity is required to recognise a non-financial liability. The past event is the start of the legal proceedings. The start of the legal proceedings obliges the entity to stand ready to perform as the court directs and hence the entity has a present obligation.

In measuring the liability at 31 December 20X8, the entity estimates a range of cash flows needed to settle the court case as follows:

Cash flow estimate	Probability assessment	Expected cash flows
\$	%	\$
Nil	95	Nil
1 000 000	5	50 000
Expected cash flow		50 000

Therefore, the total liability recognised by the entity in the balance sheet for the year ended 31 December 20X8 is \$50 000.

It should also be noted that entities may also have the opportunity to indemnify their liability for payment with a third party. To the extent that an entity is able to obtain market evidence (i.e. the amount for which the liability can be transferred to the third party on balance sheet date), this market evidence should be used to measure the liability.

Note: The facts and circumstances in the example have been simplified for the purposes of explanation and do not consider facts such as timing of cash flow and risk and uncertainties associated with the obligation.

More assets may be recognised on the balance sheet.

Contingent assets

ED 140 proposes to eliminate the term 'contingent asset' and proposes that contingent assets that satisfy the definition of an asset are measured and disclosed in accordance with the requirements of AASB 138 *Intangible Assets*, rather than AASB 137. No recognition or disclosure is proposed where an item previously described as a contingent asset does not meet the asset definition.

Constructive obligations

ED 140 proposes to amend the definition of a constructive obligation to clarify that the actions of an entity must result in other parties having a valid expectation that they can reasonably rely on the entity to discharge its responsibilities. The ED also provides additional guidance on determining whether an entity has incurred a constructive obligation.

Restructurings

An entity is only able to recognise a liability for a cost associated with a restructuring when the definition of a liability has been satisfied.

ED 140 proposes that an entity is only able to recognise a liability for a cost associated with a restructuring when the definition of a liability has been satisfied. Therefore, instead of an entity recognising a liability for all restructuring costs up front, it will recognise liabilities for restructuring costs as the liability for each expense is incurred.

These changes also give rise to amendments to AASB 119 in respect of termination benefits.

Reimbursement

The ED proposes that if an entity has an unconditional right to receive reimbursement that right should be recognised as an asset if it can be measured reliably. The current version of AASB 137 requires that a reimbursement should be recognised when receipt is virtually certain.

The changes are proposed to commence from 1 January 2007.

When are these changes proposed to take effect?

The proposals are scheduled to commence with effect from 1 January 2007. Comparative information is not restated. Earlier application of the Standard is encouraged, however, entities are only permitted to apply the Standard from the beginning of the annual period commencing on or after the date the Standard is issued. The IASB expects to release the revised Standard in 2006.

The question then becomes 'why consider the ED proposals now'? The answer lies in understanding the effect of the new requirements and planning for their implementation.

Comment period

The IASB has requested comments on the exposure draft by 28 October 2005. The AASB has requested comments on ED 140 by 23 September 2005 so that comments received can be taken into account in the AASB's own submission to the IASB.

Feedback and assistance

We welcome your feedback on the matters covered in this Accounting Alert – please email your comments to accounting_alerts@deloitte.com.au

For assistance in applying the requirements outlined in your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, **Bruce Porter** on **+61 (0) 3 9208 7490**, or by email to bruporter@deloitte.com.au

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