

PROPOSED FINANCIAL REPORTING STANDARD

ED/FRS

Exposure Draft of Proposed AMENDMENTS TO FRS 37 PROVISIONS, CONTINGENT LIABILITIES and CONTINGENT ASSETS AND FRS 19 EMPLOYEE BENEFITS

Comments to be received by 28 September 2005

This exposure draft (ED) contains proposed amendments to FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* and FRS 19 *Employee Benefits*.

This ED should be read in the context of the Preface to Financial Reporting Standards published by the Council on Corporate Disclosure and Governance.

This ED is issued by the Council on Corporate Disclosure and Governance for comment only and does not necessarily represent the views of the Council.

Since this ED may be modified as a result of comments received, the Council on Corporate Disclosure and Governance would like to hear both from those who agree with the proposals contained in the ED and from those who do not.

Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, clearly explain the problem and provide a suggestion for alternative wording with supporting reasoning.

Comments should be submitted in writing, so as to be received by **28 September 2005**, preferably by email to: accounting_stds@acra.gov.sg or addressed to:

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INTRODUCTION

- 1 This Exposure Draft of Proposed Amendments to FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* (to be retitled *Non-financial Liabilities*) and FRS 19 *Employee Benefits* has been published by the Council on Corporate Disclosure and Governance (CCDG) in view of the Short-term Convergence project and the second phase of the Business Combinations project.
- 2 The objective of short-term convergence is to reduce differences with US generally accepted accounting principles (US GAAP). Short-term convergence focuses on differences that can be resolved in a relatively short time and can be addressed outside current and planned major projects. It is one strand of the broader objective of convergence of accounting standards around the world.
- 3 The proposed amendments to the requirements in FRS 37 for constructive obligations, onerous contracts and restructuring provisions, together with the complementary amendments to the requirements in FRS 19 for termination benefits, result from the consideration of FASB Statement No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146), issued in 2002. It is believed that the proposed amendments would both improve accounting and achieve substantial convergence with the recognition requirements of SFAS 146.
- 4 The second phase of the Business Combinations project involves a broad reconsideration of the requirements on applying the purchase method (now called the 'acquisition method' in the Exposure Draft of Proposed Amendments to FRS 103 *Business Combinations*) to the accounting for business combinations. This has included reconsidering the treatment in a business combination of the contingencies of an acquiree. As a consequence, there was a proposal to eliminate the terms 'contingent asset' and 'contingent liability' in FRS 37 (and in other Standards) and to analyse afresh items previously described as such. These proposed amendments have also required a reconsideration of the probability recognition criterion in FRS 37. It is believed that these amendments achieve substantial convergence with the recognition principles underpinning FASB Interpretations No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* and No. 47 *Accounting for Conditional Asset Retirement Obligations*. Because these amendments were prompted by the second phase of the Business Combinations project, this Exposure Draft is published simultaneously with the Exposure Draft of Proposed Amendments to FRS 103. If confirmed in a Standard, the proposals in this Exposure Draft would have an effective date of 1 January 2007, the same as is proposed for the revised FRS 103.
- 5 In developing this Exposure Draft, amendments related to the decisions in the Short-term Convergence project and the second phase of the Business Combinations project were made. These amendments particularly affect the definitions and the recognition requirements. Not all of the requirements in FRS 37 and FRS 19 were reconsidered. However, opportunity was taken to clarify the scope of FRS 37. As a result, the proposal was not to use 'provision' as a defined term but instead to use the term 'non-financial liability'. Another proposal seeks to clarify some aspects of the existing measurement requirements.

INVITATION TO COMMENT

- 6 The Council on Corporate Disclosure and Governance (CCDG) invites comments on all the amendments to FRS 37 and FRS 19 proposed in this Exposure Draft and would particularly welcome answers to the questions in the Invitation to Comment. As noted above, the CCDG is not considering changes to all of the requirements in FRS 37 and FRS 19 at this time. Therefore, the CCDG is not requesting comments on aspects of those Standards not proposed for change.
- 7 Comments should be submitted in writing so as to be received no later than **28 September 2005**.

Presentation of the document

- 8 This Exposure Draft presents for the proposed amendments to each of the two Standards:
- An invitation to comment. Questions have been limited to the main issues, but the CCDG would also welcome comments on other changes proposed.
 - A summary of main changes. This section summarises the CCDG's proposals for changes to the Standard. Minor matters and editorial changes are not mentioned.
 - The revised text presented as (a) a 'clean' draft of the full text of FRS 37 and (b) a marked-up copy of the amended paragraphs of FRS 19.
 - Consequential amendments to other Standards and Interpretations of FRS.

**PROPOSED AMENDMENTS TO
FRS 37
PROVISIONS,
CONTINGENT LIABILITIES AND
CONTINGENT ASSETS**

INVITATION TO COMMENT

The CCDG would particularly welcome answers to the questions below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale, and, when applicable, provide a suggestion for alternative wording.

Question 1 – Scope of FRS 37 and terminology

The Exposure Draft proposes to clarify that FRS 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 FRS 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?

Question 2 – Contingent liabilities

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

Liabilities arise only from unconditional (or non-contingent) obligations. Hence, 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.

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.

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.

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?

Question 3 – Contingent assets

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

As with contingent liabilities, assets arise only from unconditional (or non-contingent) rights. 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.

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.

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

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?
- (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?

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 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. 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. 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 (i.e. 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 (i.e. to stand ready to honour warranty claims) will probably result in an outflow of economic benefits.

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, i.e. it is standing ready to honour warranty claims.

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?

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?

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?

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

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?

SUMMARY OF MAIN CHANGES (FRS 37)

The following main changes are proposed:

Scope of FRS 37 and terminology

- FRS 37 defines a provision as a liability of uncertain timing or amount. The Exposure Draft does not use 'provision' as a defined term and instead proposes to use the term 'non-financial liability', which includes items previously described as provisions as well as other liabilities.
- The purpose of this amendment is to clarify that FRS 37, except in specified cases, should be applied to all non-financial liabilities that are not within the scope of other Standards.

Contingent liabilities

- FRS 37 defines a contingent liability as a possible obligation or a present obligation that is not recognised. A contingent liability that is a present obligation is not recognised either because it is not probable that an outflow of resources will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability. The Standard does not permit contingent liabilities to be recognised but requires them to be disclosed, unless the possibility of any outflow of economic resources in settlement of the contingent liability is remote. The Exposure Draft:
 - proposes eliminating the term 'contingent liability'.
 - uses the term 'contingency' to refer to uncertainty about the amount that will be required to settle a liability, rather than uncertainty about whether a liability exists.
 - specifies that a liability for which the settlement amount is contingent on one or more uncertain future events is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur).
- The purpose of these amendments is:
 - to clarify that only present obligations (rather than possible obligations) of an entity give rise to liabilities and that liabilities arise from unconditional obligations.
 - to require uncertainty about future events that affect the amount that will be required to settle a liability to be reflected in the measurement of the liability.

Contingent assets

- FRS 37 defines a contingent asset as a possible asset. It does not permit contingent assets to be recognised, but requires them to be disclosed if an inflow of economic benefits is probable. The Exposure Draft:
 - proposes eliminating the term 'contingent asset'.
 - uses the term 'contingency' to refer to uncertainty about the amount of the future economic benefits embodied in an asset, rather than uncertainty about whether an asset exists.

- specifies that items previously described as contingent assets, but satisfying the definition of an asset in the *Framework*, are within the scope of FRS 38 rather than FRS 37 (except for rights to reimbursements, which remain within the scope of FRS 37).
- The purpose of the amendment is to clarify that only resources currently controlled by the entity as a result of a past transaction or event (rather than possible assets) give rise to assets and that assets arise from unconditional rights.

Constructive obligations

- FRS 37 defines a constructive obligation as an obligation that derives from an entity's actions when the entity has (a) indicated to other parties that it will accept particular responsibilities and (b) as a result has created a valid expectation on the part of those other parties that it will discharge those responsibilities. The Exposure Draft 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.
 - to provide additional guidance on determining whether an entity has incurred a constructive obligation.

Probability recognition criterion

- FRS 37 states that provisions should be recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the provision. In some cases, the examples accompanying the Standard apply this probability recognition criterion to what the Exposure Draft now analyses as conditional obligations. For example, in the case of a product warranty, the Standard explains that the entity considers the likelihood of claims arising under the warranty. In effect, this means that the entity considers whether it is probable that the *conditional* obligation will result in an outflow of resources embodying economic benefits. Consistently with the revised analysis of contingent liabilities, the probable outflow criterion should always be applied to the liability (i.e. unconditional obligation). Therefore, if an entity has a non-financial liability arising from an unconditional obligation that is accompanied by a conditional obligation, the probability recognition criterion is applied to the unconditional obligation rather than the conditional obligation. For example, in the case of a product warranty, the criterion should be applied to the unconditional obligation to stand ready to honour warranty claims (i.e. to provide warranty coverage). As a result, the probability recognition criterion is always satisfied. The Exposure Draft therefore proposes omitting the criterion from the Standard.

Measurement

- FRS 37 states that provisions should be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The best estimate is described as the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time. Although expected value is described as the basis for measuring a

provision involving a large population of items, the Standard states that the best estimate of single obligations may be the individual most likely outcome. The Exposure Draft:

- proposes that a non-financial liability should be measured at 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.
- emphasises that an expected cash flow approach can be used as the basis for measuring a non-financial liability for both a class of similar obligations and a single obligation.
- explains that measuring a non-financial liability for a single obligation at its most likely outcome would not necessarily be consistent with the Standard's measurement objective.

Reimbursement

- FRS 37 states that when expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when it is virtually certain that the reimbursement will be received. Consistently with the revised analysis of a contingent asset, the Exposure Draft 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.

Onerous contracts

- FRS 37 defines an onerous contract as one in which the unavoidable costs of meeting its obligations exceed the economic benefits expected. The entity recognises as a provision the present obligation under the contract. The Standard provides no further guidance about when the provision should be recognised. The Exposure Draft proposes:
 - additional recognition guidance to specify 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 has taken that action.
 - specifying that in the case of an onerous operating lease, the unavoidable costs of meeting the obligation should be based on the unavoidable lease commitment less any sublease rentals that the entity could reasonably obtain for the property, regardless of whether the entity intends to sublease the property.

Restructuring provisions

- FRS 37 states that an entity that (a) has a detailed formal plan for restructuring and (b) has raised a valid expectation in those affected that it will carry out the restructuring has a constructive obligation. Therefore, it recognises a provision for the direct expenditures arising from the restructuring. The Exposure Draft proposes:
 - revising the application guidance for restructuring provisions to specify that a non-financial liability for a cost associated with a restructuring is recognised only when the definition of a liability has been satisfied for that cost. Accordingly, a cost associated with a restructuring is

recognised as a liability on the same basis as if that cost arose independently of a restructuring.

- specific guidance for accounting for costs that are often associated with a restructuring as follows:
 - the cost of employee termination benefits is recognised in accordance with FRS 19 *Employee Benefits*.
 - a liability for costs that will continue to be incurred under a contract for its remaining term without equivalent economic benefit to the entity is recognised when the entity ceases using the right conveyed by the contract (in addition to any liability recognised if the contract was previously determined to be onerous).
 - the cost of terminating a contract before the end of its term is recognised when the entity terminates the contract in accordance with the contract terms.

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[Draft] Financial Accounting Standard 37 *Non-financial Liabilities* ([draft] FRS 37) is set out in paragraphs 1-73 and the Appendix. All the paragraphs have equal authority. [Draft] FRS 37 should be read in the context of its objective, the *Preface to Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[DRAFT] FINANCIAL REPORTING STANDARD 37

Non-financial Liabilities

OBJECTIVE

- 1 The objective of this [draft] Standard is to establish principles for recognising, measuring and disclosing non-financial liabilities. Those principles require an entity to recognise a non-financial liability unless it cannot be measured reliably. Uncertainty about the amount or timing of the economic benefits that will be required to settle a non-financial liability is reflected in the measurement of that liability. The principles also require an entity to disclose sufficient information to enable users of the financial statements to understand the amount and nature of an entity's non-financial liabilities and the uncertainty relating to the future outflows of economic benefits that will be required to settle them.

SCOPE

- 2 **An entity shall apply this [draft] Standard in accounting for all non-financial liabilities, except:**
 - (a) **those resulting from executory contracts, unless the contract is onerous; and**
 - (b) **those within the scope of another Standard.**
- 3 Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.
- 4 When a specific type of non-financial liability is within the scope of another Standard, an entity applies that Standard instead of this [draft] Standard. For example, some types of non-financial liabilities are within the scope of Standards on:
 - (a) construction contracts (see FRS 11 *Construction Contracts*).
 - (b) income taxes (see FRS 12 *Income Taxes*).
 - (c) employee benefits (see FRS 19 *Employee Benefits*).
 - (d) insurance contracts (see FRS 104 *Insurance Contracts*). However, this [draft] Standard applies to non-financial liabilities of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of FRS 104.
- 5 **An entity shall apply this [draft] Standard to the following contractual obligations only if they are onerous:**
 - (a) **obligations under operating leases to which FRS 17 *Leases* applies; and**
 - (b) **loan commitments excluded from the scope of FRS 39 *Financial Instruments: Recognition and Measurement*.**

- 6 Because FRS 17 contains no specific requirements for operating leases that are onerous, this [draft] Standard applies to such leases. Similarly, because FRS 39 excludes some loan commitments from its scope, this [draft] Standard applies to such loan commitments if they are onerous.
- 7 Some amounts treated as non-financial liabilities may relate to the recognition of revenue, for example when an entity issues a product warranty in exchange for a fee. This [draft] Standard does not address the recognition of revenue. FRS 18 *Revenue* identifies the circumstances in which revenue is recognised and provides guidance on the application of the recognition criteria. This [draft] Standard does not change the requirements of FRS 18.
- 8 Other Standards specify whether the corresponding amount recognised for a non-financial liability is included as part of the cost of an asset or recognised as an expense. This issue is not addressed in this [draft] Standard.
- 9 In some jurisdictions, some classes of liabilities are described as provisions, for example those liabilities that can be measured only by using a substantial degree of estimation. Although this [draft] Standard does not use the term 'provision', it does not prescribe how entities should describe their non-financial liabilities. Therefore, entities may describe some classes of non-financial liabilities as provisions in their financial statements.

DEFINITIONS

- 10 The following terms are used in this [draft] Standard with the meanings specified:

A *constructive obligation* is a present obligation that arises 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.

A *legal obligation* is a present obligation that arises from the following:

- (a) a contract (through its explicit or implicit terms);
- (b) legislation; or
- (c) other operation of law.

A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

A *non-financial liability* is a liability other than a financial liability as defined in FRS 32 *Financial Instruments: Disclosure and Presentation*.

A contract is *onerous* when the unavoidable costs of meeting its obligations exceed its expected economic benefits.

RECOGNITION

11 An entity shall recognise a non-financial liability when:

- (a) the definition of a liability has been satisfied, and
- (b) the non-financial liability can be measured reliably.

Satisfying the definition of a liability

12 Items are recognised as non-financial liabilities in accordance with this [draft] Standard only if they satisfy the definition of a liability in the *Framework*.

13 An essential characteristic of a liability is that the entity has a present obligation arising from a past event. For a past event to give rise to a present obligation, the entity must have little, if any, discretion to avoid settling it. A past event that creates a present obligation is sometimes referred to as an obligating event.

14 Because most liabilities arise from legal obligations, settlement can be enforced by a court. Some liabilities arise from constructive obligations, in which the obligation is created by, or inferred from, an entity's past actions rather than arising from an explicit agreement with another party or from legislation. In some jurisdictions, constructive obligations may also be enforced by a court, for example in accordance with the legal principle known in the United States as promissory estoppel* or principles having the same effects under other legal systems.

15 In the absence of legal enforceability, particular care is required in determining whether an entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this will be the case only if:

- (a) the entity has indicated to other parties that it will accept particular responsibilities;
- (b) the other parties can reasonably expect the entity to perform those responsibilities; and
- (c) the other parties will either benefit from the entity's performance or suffer harm from its non-performance.

16 In determining whether a liability exists at the balance sheet date, an entity takes into account all available evidence, for example the opinion of experts. The evidence considered includes any additional information provided by events after the balance sheet date, but only to the extent that the information provides evidence of circumstances that existed at the balance sheet date.

17 Only present obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) result in liabilities. For example, an entity has a liability for its obligation to decommission an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused.

* Defined in *Black's Law Dictionary* as 'the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment.'

Regardless of its future actions, the entity has little, if any, discretion to avoid settling that obligation.

- 18 An intention to incur an outflow of economic resources embodying economic benefits in the future is not sufficient to give rise to a liability, even if the outflow is necessary for the continuation of the entity's future operations. For example, because of commercial pressures or legal requirements, an entity may intend or need to incur expenditure to operate in a particular way in the future (for example, by installing smoke filters in a particular type of factory). Because the entity has the discretion to avoid the future expenditure by its future actions, for example by changing its operations, it has no present obligation for that future expenditure and a liability does not exist.
- 19 A present obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the specific party to whom the obligation is owed—indeed, the obligation may be to the public at large. Because a liability always involves an obligation to another party, it follows that a decision by the management of an entity does not normally give rise to a present obligation at the balance sheet date. A present obligation arises only if the decision has been communicated before the balance sheet date to those it affects in a sufficiently specific manner to raise a valid expectation in them that they can reasonably rely on the entity to perform.
- 20 An event that does not give rise to a present obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused there may be no present obligation to remedy the consequences. However, a present obligation arises if a new law requires the existing damage to be rectified or if the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.
- 21 When a new law is proposed, a present obligation under the operation of that law arises only when the law is substantively enacted, which is when the remaining steps in the enactment process will not change the outcome. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make legislation substantively enacted in all jurisdictions. In some cases, substantive enactment does not occur until the legislation is actually enacted.

Contingencies

- 22 In some cases, an entity has a liability even though the amount that will be required to settle that liability is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In such cases, an entity has incurred two obligations as a result of a past event—an unconditional obligation and a conditional obligation.
- 23 When the amount that will be required to settle a liability is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability arising from the unconditional obligation 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.
- 24 Liabilities for which the amount that will be required in settlement is contingent on the occurrence or non-occurrence of a future event are sometimes referred to as 'stand ready' obligations. This is because the entity has an unconditional obligation to stand ready to fulfil the conditional obligation *if* the uncertain future event occurs (or fails to occur). The liability is the unconditional obligation to provide a service, which results in an outflow of economic benefits.

- 25 An example of a stand ready obligation is a product warranty. The issuer of a product warranty has an unconditional obligation to stand ready to repair or replace the product (or, expressed another way, to provide warranty coverage over the term of the warranty) and a conditional obligation to repair or replace the product if it develops a fault. The issuer recognises its liability arising from its unconditional obligation to provide warranty coverage. Uncertainty about whether the product will require repair or replacement (i.e. the conditional obligation) is reflected in the measurement of the liability.
- 26 Similarly, an entity that is involved in defending a lawsuit recognises the liability arising from its unconditional obligation to stand ready to perform as the court directs. Uncertainty about the possible penalties the court may impose (i.e. the conditional obligation) is reflected in the measurement of the liability.

Reliable measurement

- 27 In many cases, the amount of a non-financial liability must be estimated. The use of estimates is an essential part of the preparation of financial statements and does not of itself undermine the reliability of the statements. Except in extremely rare cases, an entity will be able to determine a reliable measure of a liability.
- 28 In the extremely rare case in which an entity cannot measure reliably a non-financial liability, the liability does not qualify for recognition in accordance with this [draft] Standard. In such cases, the entity discloses information about the non-financial liability in accordance with paragraph 69. The non-financial liability is recognised initially in the period in which it can be measured reliably.

MEASUREMENT

Amount that an entity would rationally pay to settle or transfer the obligation

- 29 **An entity shall 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.**
- 30 In some cases, contractual or other market evidence can be used to determine the amount that would be required to settle or transfer the obligation on the balance sheet date. However, in many cases, observable market evidence of the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party will not exist and the amount must be estimated.
- 31 The basis of estimating many non-financial liabilities will be an expected cash flow approach, in which multiple cash flow scenarios that reflect the range of possible outcomes are weighted by their associated probabilities. An expected cash flow approach is an appropriate basis for measuring both liabilities for a class of similar obligations and liabilities for single obligations. This is because it is likely to be the basis of the amount that an entity would rationally pay to settle the obligation(s) or to transfer the obligation(s) to a third party on the balance sheet date. In contrast, a liability for a single obligation measured at its most likely outcome would not necessarily represent the amount that the entity would rationally pay to settle or to transfer the obligation on the balance sheet date.

- 32 The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience with similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional information provided by events after the balance sheet date, but only to the extent that the information relates to the obligation existing at the balance sheet date.
- 33 When an entity is estimating the amount of a non-financial liability that is contingent on the occurrence (or non-occurrence) of one or more uncertain future events, the measurement of the liability reflects the uncertainty about the future event(s). For example, in estimating a liability for a product warranty obligation, an entity considers the likelihood of claims under the warranty occurring and the amount and timing of the cash flows that would be required to meet those claims.
- 34 The non-financial liability is measured before tax, because the tax consequences of the liability, and changes in it, are accounted for in accordance with FRS 12.

Risks and uncertainties

- 35 **In measuring a non-financial liability in accordance with paragraph 29, an entity shall include the effects of risks and uncertainties.**
- 36 Risk describes variability of outcome. A risk adjustment typically increases the amount at which a liability is measured relative to a measurement that does not include a risk adjustment, all other things being equal. This is because it reflects the price that entities demand for the uncertainties and unforeseeable circumstances inherent in the liability. Caution is needed in making judgements under conditions of uncertainty, so that liabilities are not understated. However, uncertainty does not justify deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated at the high end of the range of those reasonably expected, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a non-financial liability.
- 37 The uncertainties about the amount or timing of the outflow of economic benefits are disclosed in accordance with paragraph 68(c).

Present value

- 38 **When an entity measures a non-financial liability using an estimation method that involves projections of future cash flows, it shall discount the cash flows using a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.***
- 39 Because of the time value of money, estimated cash outflows that arise soon after the balance sheet date are more onerous than those of the same amount that arise later. Therefore, cash flows are discounted.
- 40 When an entity reflects the effects of risks and uncertainties by adjusting the discount rate rather than by adjusting the estimated cash flows, the resulting discount rate is typically lower than a risk-free rate.

* Further guidance on using cash flow information and present value in accounting measurements is contained in Appendix A of FRS 36 *Impairment of Assets*.

Future events

41 When measuring a non-financial liability, an entity shall reflect the effects of future events that may affect the amount that will be required to settle the obligation.

42 Only the effects of future events that may affect the amount that will be required to settle an obligation without changing the nature of the obligation are reflected in the measurement of a non-financial liability. For example, an entity's past experience may indicate that the cost of cleaning up a site at the end of its life may be reduced by future changes in technology. Accordingly, when measuring the liability, the entity reflects an assessment of both the assumed effects of the future technology on the cost of cleaning up the site and the likelihood that such technology will be available. In contrast, the effects of future events that create new obligations (or change or discharge existing obligations) are not reflected in the measurement of a liability. For example, the effects of possible new legislation are not reflected in the measurement of a liability because they create or change the obligation itself.

Subsequent measurement

43 An entity shall review the carrying amount of a non-financial liability at each balance sheet date and adjust it to reflect the current amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party on that date.

44 An entity subsequently remeasures a non-financial liability in accordance with paragraphs 30-42. Therefore, remeasurement reflects any changes in:

- (a) the expected amount and timing of the economic benefits that will be required to settle the obligation;
- (b) the risks and uncertainties surrounding the obligation; and
- (c) the discount rate used to measure the liability.

45 Changes in the carrying amount of a non-financial liability resulting from the passage of time are recognised as a borrowing cost.

REIMBURSEMENTS

46 When an entity has a right to be reimbursed by a third party 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. The amount recognised for the reimbursement right shall not exceed the amount of the non-financial liability.

47 Sometimes, an entity has a right to look to another party to provide part or all of the economic benefits that will be required to settle a non-financial liability (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or settle the amounts directly. Although the reimbursement itself is a conditional right, the unconditional right to receive reimbursement satisfies the definition of an asset and is recognised if it can be measured reliably.

48 An entity shall not offset against the non-financial liability the amount recognised for the reimbursement right.

49 Because the reimbursement is receivable from a third party, there would not be a legally enforceable right of set-off and, therefore, the non-financial liability and the reimbursement right are recognised separately. However, if the entity will not be liable for the amounts required to settle the obligation if the third party fails to pay, the entity has no liability for these amounts and they are not reflected in the measurement of the liability.

50 In the income statement, the expense relating to a non-financial liability may be presented net of the income resulting from the reimbursement right.

DERECOGNITION

51 An entity shall derecognise a non-financial liability when the obligation is settled, is cancelled or expires.

APPLICATION OF THE RECOGNITION AND MEASUREMENT REQUIREMENTS

Future operating losses

52 An entity shall not recognise a liability for future operating losses.

53 Future operating losses do not satisfy the definition of a liability because there is no present obligation arising from a past event.

54 An expectation by the entity of future operating losses is an indication that some assets of the entity may be impaired or that some of its contracts may be onerous. An entity tests these assets for impairment in accordance with FRS 36 *Impairment of Assets* and accounts for its onerous contracts in accordance with paragraphs 55-59.

Onerous contracts

55 If an entity has a contract that is onerous, it shall recognise as a liability the present obligation under the contract. If the contract will become onerous as a result of the entity's own actions, the entity shall not recognise the liability until it has taken the action.

56 Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party and, therefore, there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. If events or circumstances make such a contract onerous, the contract is within the scope of this [draft] Standard and a liability exists that is recognised. Executory contracts that are not onerous are outside the scope of this [draft] Standard.

57 In some cases, contracts become onerous as a result of events outside the entity's control. For example, a contract that requires an entity to make specified payments regardless of whether it takes delivery of contracted products or services may become onerous if the market price of the products or services declines below the contracted

price. In other cases, the event that makes the contract onerous is an action of the entity. In such cases, the liability for the onerous contract is not recognised until the entity has taken the action. For example, a contract may become onerous because the entity ceases to use the right conveyed by that contract, but continues to incur costs for its obligations under the contract. Therefore, in this example the entity does not recognise a liability until it ceases using the right conveyed by the contract.

- 58 A contract is onerous when the unavoidable costs of meeting its obligations exceed its expected economic benefits. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. If the contract is an operating lease, the entity determines the unavoidable cost by reference to the remaining lease rentals payable, reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease.
- 59 Before an entity recognises a liability for an onerous contract, it recognises any impairment loss that has occurred on assets related to that contract (see FRS 36).

Restructurings

- 60 The following are examples of events that are typically described as a restructuring:
- (a) sale or termination of a line of business;
 - (b) closure of business locations in a country or region or relocation of business activities from one country or region to another;
 - (c) changes in management structure, for example, eliminating a layer of management; and
 - (d) reorganisations that affect the nature and focus of the entity's operations.
- 61 **An entity shall recognise a non-financial liability for a cost associated with a restructuring only when the definition of a liability has been satisfied.**

- 62 A liability involves a present obligation to others that leaves the entity with little, if any, discretion to avoid settling the obligation. 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. 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.

Termination benefits

- 63 An entity shall apply the requirements in paragraphs 132-147 of [draft] FRS 19 to benefits that are provided in connection with the termination of an employee's employment.

Contract termination costs

- 64 An entity shall apply the requirements in paragraphs 55-59 to costs to terminate a contract before the end of its term and to costs that will continue to be incurred under a contract for its remaining term without equivalent economic benefit to the entity.

Accordingly, a liability for costs to terminate a contract that was not previously determined to be an onerous contract before the end of its term shall be recognised when the entity terminates the contract in accordance with the contract terms. For example, termination would occur when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty. Similarly, a liability for costs that will continue to be incurred under a contract that was not previously determined to be onerous for its remaining term without economic benefit to the entity shall be recognised when the entity ceases using the right conveyed by the contract. For example, any additional liability for payments to be made under an operating lease for a factory that will no longer be used is recognised when the entity ceases to use the leased factory.

Other associated costs

- 65 Other costs associated with a restructuring include, but are not limited to, such costs as:
- (a) retraining or relocating continuing staff;
 - (b) consolidating or closing facilities; or
 - (c) investing in new systems and distribution networks.

An entity shall recognise liabilities for such costs when the liability is incurred (generally, when goods or services associated with the activity are received).

- 66 If an entity starts to implement a restructuring plan or announces its main features after the balance sheet date, disclosure is required in accordance with FRS 10 *Events after the Balance Sheet Date*.

DISCLOSURE

- 67 **For each class of recognised non-financial liability, an entity shall disclose the carrying amount of the liability at the period-end together with a description of the nature of the obligation.**
- 68 **For any class of recognised non-financial liability with estimation uncertainty, an entity shall also disclose:**
- (a) **a reconciliation of the carrying amounts at the beginning and end of the period showing:**
 - (i) **liabilities incurred;**
 - (ii) **liabilities derecognised;**
 - (iii) **changes in the discounted amount resulting from the passage of time and the effect of any change in the discount rate; and**
 - (iv) **other adjustments to the amount of the liability (e.g. revisions in estimated cash flows that will be required to settle it).**
 - (b) **the expected timing of any resulting outflows of economic benefits.**
 - (c) **an indication of the uncertainties about the amount or timing of those outflows. If necessary to provide adequate information, an entity shall**

disclose the major assumptions made about future events, as described in paragraph 41.

- (d) the amount of any right to reimbursement, stating the amount of any asset that has been recognised for that right.**
- 69 If a non-financial liability is not recognised because it cannot be measured reliably, an entity shall disclose that fact together with:**
- (a) a description of the nature of the obligation;**
 - (b) an explanation of why it cannot be measured reliably;**
 - (c) an indication of the uncertainties relating to the amount or timing of any outflow of economic benefits; and**
 - (d) the existence of any right to reimbursement.**
- 70 In determining which non-financial liabilities may be aggregated to form a class, an entity considers whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs 67-69. Thus, it may be appropriate to treat as a single class of non-financial liabilities amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts subject to legal proceedings.**
- 71 In extremely rare cases, disclosure of some or all of the information required by paragraphs 68 and 69 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the non-financial liability. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.**

TRANSITION AND EFFECTIVE DATE

- 72 An entity shall apply this [draft] Standard from the beginning of its first annual period commencing on or after [1 January 2007]. Comparative information shall not be restated. Earlier application is encouraged. However, an entity shall apply this [draft] Standard only from the beginning of an annual period commencing on or after [date the [draft] Standard is issued]. If an entity applies this [draft] Standard before the effective date, it shall disclose that fact.**

WITHDRAWAL OF FRS 37 (ISSUED 2003)

- 73 This [draft] Standard supersedes FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* (issued in 2003).**

Appendix

Amendments to other pronouncements

The amendments in this [draft] Appendix shall be applied from the beginning of annual periods commencing on or after [1 January 2007]. If an entity applies this [draft] Standard from the beginning of an earlier annual period, these amendments shall be applied for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

A1 In Financial Reporting Standards (including Interpretations of Financial Reporting Standards) applicable at [1 January 2007] references to the current version of FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* are amended to FRS 37 *Non-financial Liabilities*.

A2 FRS 101 *First-time Adoption of Financial Reporting Standards* is amended as described below.

Paragraphs 9, 10, 12 and 26 are amended as follows.

9 The transitional provisions in other FRSs apply to changes in accounting policies made by an entity that already uses FRSs; they do not apply to a *first-time adopter's* transition to FRSs, except as specified in paragraphs 25D, and 34A and 34B -34C.

10 Except as described in paragraphs 13-34C, an entity shall, in its opening FRS balance sheet:
...

12 This FRS establishes two categories of exceptions to the principle that an entity's opening FRS balance sheet shall comply with each FRS:
...

(b) paragraphs 26-34BC prohibit retrospective application of some aspects of other FRSs.

26 This FRS prohibits retrospective application of some aspects of other FRSs relating to:
...

(c) estimates (paragraphs 31-34); ~~and~~

(d) assets classified as held for sale and discontinued operations (paragraphs 34A and 34B); ~~and~~

(e) non-financial liabilities (paragraph 34C).

After paragraph 34B a new heading and paragraph 34C are added as follows.

Non-financial liabilities

34C A first-time adopter shall apply FRS 37 (as revised in [2006]) for annual periods and comparative periods beginning on or after [1 January 2007]. A first-time adopter is encouraged, but not required, to apply FRS 37 (as revised in [2006]) for annual periods and comparative periods beginning on or after [date revised FRS 37 is issued]. Otherwise, it shall apply the version of FRS 37 in effect before the revisions made in [2006].

In the Implementation Guidance, Example 1 is amended as follows.

IG Example 1 Estimates
<p>Background</p> <p>Entity A's first FRS financial statements have a reporting date of 31 December 2005 and include comparative information for one year. In its previous GAAP financial statements for 31 December 2003 and 2004, entity A:</p> <ul style="list-style-type: none">(a) made estimates of accrued expenses and provisions <u>other liabilities</u> at those dates; <u>and</u>(b) accounted on a cash basis for a defined benefit pension plan; and(c) did not recognise a provision for a court case arising from events that occurred in September 2004. When the court case was concluded on 30 June 2005, entity A was required to pay 1,000 and paid this on 10 July 2005. <p>In preparing its first FRS financial statements, entity A concludes that its estimates under previous GAAP of accrued expenses and provisions <u>other liabilities</u> at 31 December 2003 and 2004 were made on a basis consistent with its accounting policies under FRSs. Although some of the accruals and provisions <u>liabilities</u> turned out to be overestimates and others to be underestimates, entity A concludes that its estimates were reasonable and that, therefore, no error had occurred. As a result, accounting for those over- and underestimates involves the routine adjustment of estimates under FRS 8.</p> <p>Application of requirements</p> <p>In preparing its opening FRS balance sheet at 1 January 2004 and in its comparative balance sheet at 31 December 2004, entity A:</p> <ul style="list-style-type: none">(a) does not adjust the previous estimates for accrued expenses and provisions <u>other liabilities</u>; <u>and</u>(b) makes estimates (in the form of actuarial assumptions) necessary to account for the pension plan under FRS 19 <i>Employee Benefits</i>. Entity A's actuarial assumptions at 1 January 2004 and 31 December 2004 do not reflect conditions that arose after those dates. For example, entity A's:<ul style="list-style-type: none">(i) discount rates at 1 January 2004 and 31 December 2004 for the pension plan and for provisions <u>other liabilities</u> reflect market conditions at those dates; <u>and</u>(ii) actuarial assumptions at 1 January 2004 and 31 December 2004 about future employee turnover rates do not reflect conditions that arose after those dates—such as a significant increase in estimated employee turnover rates as a result of a curtailment of the pension plan in 2005. <p>The treatment of the court case at 31 December 2004 depends on the reason why entity A did not recognise a provision under previous GAAP at that date.</p> <p style="text-align: right;"><i>continued...</i></p>

~~**Assumption 1** — Previous GAAP was consistent with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Entity A concluded that the recognition criteria were not met. In this case, entity A's assumptions under FRSs are consistent with its assumptions under previous GAAP. Therefore, entity A does not recognise a provision at 31 December 2004.~~

~~**Assumption 2** — Previous GAAP was not consistent with FRS 37. Therefore, entity A develops estimates under FRS 37. Under FRS 37, an entity determines whether an obligation exists at the balance sheet date by taking account of all available evidence, including any additional evidence provided by events after the balance sheet date. Similarly, under FRS 10 *Events after the Balance Sheet Date*, the resolution of a court case after the balance sheet date is an adjusting event after the balance sheet date if it confirms that the entity had a present obligation at that date. In this instance, the resolution of the court case confirms that entity A had a liability in September 2004 (when the events occurred that gave rise to the court case). Therefore, entity A recognises a provision at 31 December 2004. Entity A measures that provision by discounting the 1,000 paid on 10 July 2005 to its present value, using a discount rate that complies with FRS 37 and reflects market conditions at 31 December 2004.~~

In paragraph IG13 of the Implementation Guidance, 'provision' is amended to 'non-financial liability'.

In the Implementation Guidance, Example 3 is amended as follows.

<p>IG Example 3 Business combination— <u>liability for costs associated with a restructuring provision</u></p>
<p>Background</p> <p>Entity D's first FRS financial statements have a reporting date of 31 December 2005 and include comparative information for 2004 only. On 1 July 2003, entity D acquired 100 per cent of subsidiary E. <u>Amounts reported as liabilities by entity D in accordance with its previous GAAP, entity D recognised an (undiscounted) included expected restructuring provision costs</u> of 100 that would not have qualified as an identifiable liability under FRS 103. The recognition of this restructuring provision <u>these costs as a liability</u> increased goodwill by 100. At 31 December 2003 (date of transition to FRSs), entity D:</p> <ul style="list-style-type: none">(a) had paid restructuring costs of 60; and(b) estimated that it would pay further costs of 40 in 2004, and that the effects of discounting were immaterial. At 31 December 2003, those further costs did not qualify for recognition as a provision under non-financial liability in accordance with FRS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> <u>Non-financial Liabilities</u> <p>Application of requirements</p> <p>In its opening FRS balance sheet, entity D:</p> <ul style="list-style-type: none">(a) does not recognise a <u>liability for restructuring provision costs</u> (paragraph B2(c) of the FRS).(b) does not adjust the amount assigned to goodwill. However, entity D tests the goodwill for impairment under <u>in accordance with FRS 36 <i>Impairment of Assets</i></u>, and recognises any resulting impairment loss (paragraph B2(g)).(c) as a result of (a) and (b), reports retained earnings in its opening FRS balance sheet that are higher by 40 (before income taxes, and before recognising any impairment loss) than in the balance sheet at the same date under previous GAAP.

In paragraphs IG40 and IG41 of the Implementation Guidance, 'provision' is amended to 'non-financial liability'.

After paragraph IG41 of the Implementation Guidance, example 10A is added as follows.

IG Example 10A FRS 37—recognition of a non-financial liability not recognised in accordance with previous GAAP

Background

Entity A's first FRS financial statements have a reporting date of 31 December 2008 and include comparative information for one year. In its previous GAAP financial statements for 31 December 2007, entity A did not recognise a liability for a lawsuit filed in December 2007 relating to events that were alleged to have occurred in September 2007. When the ensuing court case was concluded on 30 June 2008, entity A was required to pay 1,000.

Application of requirements

In preparing its opening FRS balance sheet at 1 January 2007 and in its comparative balance sheet at 31 December 2007, entity A develops estimates necessary to account for the lawsuit in accordance with FRS 37. FRS 37 requires an entity to determine whether an obligation exists at the balance sheet date by taking account of all available evidence, including any additional evidence provided by events after the balance sheet date, but only to the extent that the information provides evidence of circumstances that existed at the balance sheet date. Similarly, in accordance with FRS 10 *Events after the Balance Sheet Date*, the receipt of information after the balance sheet date is an adjusting event after the balance sheet date if it indicates that the entity had a present obligation at that date. In this example, the start of legal proceedings indicates that the entity had a liability at 31 December 2007. Therefore, entity A recognises a non-financial liability at 31 December 2007. Entity A measures that liability by estimating the amount that it would have rationally paid to settle or transfer the obligation on 31 December 2007. Accordingly, measurement reflects the circumstances existing on 31 December 2007.

In the Implementation Guidance, paragraph IG42 is amended as follows.

IG42 The transitional provisions in FRS 36 ~~and FRS 37~~ do not apply to an entity's opening FRS balance sheet (paragraph 9 of the FRS). Paragraph 34C of the FRS specifies when a first-time adopter applies [draft] FRS 37 (as revised in [2006]). For example, a first-time adopter that has a reporting date for its first FRS financial statements of 31 December 2007 and presents comparative information in those financial statements for one year, is required to apply FRS 37 (as revised in [2006]) from [1 January 2007]. The first-time adopter applies in its comparative information the version of FRS 37 in effect before the revisions made in [2006].

In Example 11 of the Implementation Guidance, in the reconciliation of equity at 1 January 2004, notes 7 and 9 to the reconciliation of equity at 1 January 2004, and note 4 to the reconciliation of profit or loss for 2004, 'restructuring provision' is amended to 'liability for costs associated with restructuring'.

In the Implementation Guidance, paragraph IG201 is amended as follows.

IG201 FRS 16 requires the cost of an item of property, plant and equipment to include the initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located. FRS 37 requires the liability, both initially and subsequently, to be measured at the amount required that an entity would rationally pay to settle the present obligation or to transfer it to a third party at on the balance sheet date, ~~reflecting a current market-based discount rate.~~

A3 FRS 104 *Insurance Contracts* is amended as described below.

Paragraph 14(a) is amended as follows.

- (a) shall not recognise as a liability any ~~provisions~~ amounts for possible future claims, if those claims arise under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions).

In the Implementation Guidance, 'provisions' in paragraphs IG22 and IG45 is amended to 'liabilities'.

In the Implementation Guidance, paragraph IG50 is amended as follows.

IG50 An insurer might also disclose the following information, which need not be disaggregated by broad classes:

...

- (e) the terms of any obligation ~~or contingent~~ (including a stand ready obligation) for the insurer to contribute to government or other guarantee funds (see also FRS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities*).

...

A4 FRS 1 *Presentation of Financial Statements* is amended as described below.

Paragraphs 34(b), 56, 68, 75, 87, 105, 117 and 124 are amended as follows.

34(b) ~~expenditure~~ the expense related to a ~~provision~~ non-financial liability that is recognised in accordance with FRS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ *Non-financial Liabilities* and ~~reimbursed under a contractual arrangement with~~ for which the entity has a right to reimbursement from a third party (for example, a supplier's warranty agreement) may be netted against the income resulting from the related reimbursement right.

56 Information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity. FRS 32 requires disclosure of the maturity dates of financial assets and financial liabilities. Financial assets include trade and other receivables, and financial liabilities include trade and other payables. Information on the expected date of recovery and settlement of non-monetary assets and liabilities such as inventories and ~~provisions~~ non-financial liabilities is also useful, whether or not assets and liabilities are classified as current or non-current. For example, an entity discloses the amount of inventories that are expected to be recovered more than twelve months after the balance sheet date.

- 68 As a minimum, the face of the balance sheet shall include line items that present the following amounts to the extent that they are not presented in accordance with paragraph 68A:
- ...
- (d) financial assets (excluding amounts shown under (e), (h) ~~and~~ or (i));
 - ...
 - (j) trade and other payables;
 - ~~(k) provisions;~~
 - ~~(k)~~ (l) financial liabilities (excluding amounts shown under (j) ~~and (k)~~);
 - (l) non-financial liabilities (excluding amounts shown under (m) or (n));
 - ...
- 75 The detail provided in subclassifications depends on the requirements of FRSs and on the size, nature and function of the amounts involved. The factors set out in paragraph 72 also are used to decide the basis of subclassification. The disclosures vary for each item, for example:
- ...
- (d) ~~provisions are disaggregated into provisions for employee benefits and other items~~ non-financial liabilities are disaggregated into classes in accordance with FRS 37; and
 - ...
- 87 Circumstances that would give rise to the separate disclosure of items of income and expense include:
- ...
- (b) ~~costs associated with~~ restructurings of the activities of an entity ~~and reversals of any provisions for the costs of restructuring;~~
 - ...
 - (g) ~~other reversals of provisions~~ non-financial liabilities.
- 105 Notes are normally presented in the following order, which assists users in understanding the financial statements and comparing them with financial statements of other entities:
- ...
- (d) other disclosures, including:
 - (i) ~~contingent liabilities~~ non-financial liabilities that have not been recognised (see in accordance with FRS 37) and unrecognised contractual commitments; and
 - ...
- 117 Determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the balance sheet date.

For example, in the absence of recently observed market prices used to measure the following assets and liabilities, future-oriented estimates are necessary to measure:

- (a) the recoverable amount of classes of property, plant and equipment,
- (b) the effect of technological obsolescence on inventories,
- (c) ~~provisions~~ non-financial liabilities subject to the future outcome of litigation in progress, and
- (d) long-term employee benefit liabilities such as pension obligations.

These estimates involve assumptions about such items as the risk adjustment to cash flows or discount rates used, future changes in salaries and future changes in prices affecting other costs.

- 124 The disclosure of some of the key assumptions that would otherwise be required in accordance with paragraph 116 is required by other Standards. For example, FRS 37 requires disclosure, in specified circumstances, of major assumptions concerning future events affecting classes of ~~provisions~~ non-financial liabilities. FRS 32 requires disclosure of significant assumptions applied made in estimating fair values of financial assets and financial liabilities that are carried at fair value. FRS 16 requires disclosure of significant assumptions applied made in estimating fair values of revalued items of property, plant and equipment.

In the Implementation Guidance, in the illustrative balance sheet after paragraph IG4, 'provisions' is amended to 'non-financial liabilities'.

- A5 In FRS 2 *Inventories*, 'provisions' in paragraph 31 is amended to 'liabilities'.
- A6 In FRS 7 *Cash Flow Statements*, 'provisions' in paragraph 20(b) is amended to 'non-financial liabilities'.
- A7 In FRS 10 *Events after the Balance Sheet Date*, paragraphs 9, 20 and 22 are amended as follows.
- 9 The following are examples of adjusting events after the balance sheet date that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

- (a) the ~~settlement~~ receipt of information after the balance sheet date ~~of a court case that confirms indicates~~ that the entity had a present obligation at the balance sheet date. The entity ~~adjusts any previously recognised provision related to this court case~~ recognises a non-financial liability in accordance with FRS 37 ~~Provisions, Contingent Liabilities and Contingent Assets~~ Non-financial Liabilities or recognises a new provision. The entity ~~does not merely disclose a contingent liability~~ because the settlement information provides additional evidence that would be considered in accordance with paragraph 16 of FRS 37. For example, the start of legal proceedings against an entity after the balance sheet date may indicate that the entity had a present obligation at the balance sheet date.

...

- 20 In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the balance sheet date, even when the information does not affect the amounts that it recognises in its financial statements. One example of the need to update disclosures is when evidence becomes available after the balance sheet date about a ~~contingent~~ non-financial liability that existed at the balance sheet date. In addition to considering whether it ~~should recognise or change a provision under the evidence affects the measurement of the non-financial liability recognised in accordance with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*~~, an entity updates its disclosures about the ~~contingent~~ non-financial liability in the light of that evidence.
- 22 The following are examples of non-adjusting events after the balance sheet date that would generally result in disclosure:
...
(i) entering into significant commitments or ~~contingent~~ incurring significant liabilities, for example, by issuing significant guarantees; and
...
A8 In FRS 11 *Construction Contracts*, paragraph 45 is replaced and paragraph 45A is added, as follows.
- 45 An entity shall disclose the following information about the key estimation uncertainties relating to construction contracts:**
- (a) a description of the uncertainty; and
- (b) an indication of its possible financial effects on amounts recognised for construction contracts and the timing of those effects.
- 45A Estimation uncertainty may relate to amounts recognised in the financial statements (for example, warranty costs, penalties and expected losses) and amounts that are not recognised (for example, claims not yet accepted by the customer). The entity discloses information to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing.
- A9 FRS 12 *Income Taxes* is amended as described below.
Paragraph 88 is replaced and paragraphs 88A and 88B are added, as follows.
- 88 An entity shall disclose the following information about the key estimation uncertainties relating to taxes:**
- (a) a description of the uncertainty; and
- (b) an indication of its possible financial effects on amounts recognised for taxes and the timing of those effects.

88A Estimation uncertainty may relate to both recognised and unrecognised tax assets and liabilities. The entity discloses information to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing (for example, the effects of unresolved disputes with the taxation authorities).

88B When changes in tax rates or tax laws are substantively enacted after the balance sheet date, an entity discloses the effect of those changes on its current and deferred tax assets and liabilities (see FRS 10 *Events after the Balance Sheet Date*).

In Appendix B, Example 2 is amended as follows.

Example 2 - Deferred Tax Assets and Liabilities

...

In X5, the entity was notified by the relevant authorities that they intend to pursue an action against the entity with respect to sulphur emissions. ~~Although as at December X6 the action had not yet come to court~~ Accordingly, the entity recognised a liability of 700 in X5, being its best estimate of the fine arising from which reflected the likelihood that the entity would be required to pay a fine as a result of the action. Fines are not deductible for tax purposes.

...

A10 FRS 14 *Segment Reporting* is amended as described below.

In paragraph 20, 'provisions' is amended to 'liabilities'.

Paragraph 60 is amended as follows.

60 FRS 1 requires that when items of income and expense are material, their nature and amount shall be disclosed separately. FRS 1 offers a number of examples, including write-downs of inventories and property, plant, and equipment, provisions for costs associated with restructurings the activities of an entity, disposals of property, plant, and equipment and long-term investments, discontinued operations, litigation settlements, and reversals of provisions non-financial liabilities. Paragraph 59 is not intended to change the classification of any such items or to change the measurement of such items. The disclosure encouraged by that paragraph, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the entity level to the segment level.

A11 In FRS 17 *Leases*, paragraph 34A is added as follows.

34A Lessees shall apply FRS 37 *Non-financial Liabilities* to any operating lease obligation that is onerous. FRS 37 explains when a contract is onerous.

A12 FRS 18 *Revenue* is amended as described below.

In paragraph 16(a), 'provisions' is amended to 'terms'.

Paragraph 36 is replaced and paragraph 36A is added, as follows.

36 An entity shall disclose the following information about the key estimation uncertainties relating to revenue:

- (a) a description of the uncertainty; and
- (b) an indication of its possible financial effects on amounts recognised for revenue and the timing of those effects.

36A Estimation uncertainty may relate to amounts recognised in the financial statements (for example, when revenue is recognised only to the extent of costs incurred because the outcome of the transaction cannot be estimated reliably) and amounts that are not recognised (for example, claims not yet accepted by the customer). The entity discloses information to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing.

A13 In FRS 19 *Employee Benefits*, paragraphs 3, 17-19, 32B, 52, 69, 104A and 104C are amended as follows, and paragraph 125 is deleted.*

3 The employee benefits to which this Standard applies include those provided:

...

- (c) by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation ~~where~~ when the entity has ~~no realistic alternative~~ little, if any, discretion ~~but to avoid paying the employee benefits and the employees can reasonably rely on the entity to pay those benefits.~~ An example of a constructive obligation is ~~where~~ when a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

17 An entity shall recognise the expected cost of profit-sharing and bonus payments ~~under~~ in accordance with paragraph 10 ~~when, and only when~~:

- (a) the entity has a present legal or constructive obligation to make such payments as a result of past events; and
- (b) a reliable estimate of the obligation can be made.

A present obligation exists ~~when, and only when~~, the entity has ~~no realistic alternative but~~ little, if any, discretion to ~~avoid~~ make ~~making~~ the payments.

18 Under some profit-sharing plans, employees receive a share of the profit only if they remain with the entity for a specified period. Such plans create an ~~constructive~~ obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such ~~constructive~~ obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.

19 An entity may have no legal obligation to pay a bonus. Nevertheless, in some cases, an entity has a long-standing practice of paying bonuses. In such cases, the entity ~~has~~ may have a constructive obligation ~~because~~ if the entity has ~~no~~

* Other amendments to FRS 19 resulting from the amendments to the requirements in FRS 37 for restructuring provisions are included in the Proposed Amendments to FRS 19.

~~realistic alternative but little, if any, discretion to avoid paying the bonus and the employees can reasonably rely on the entity to pay the bonus.~~ The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.

32B ~~FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* Non-financial Liabilities requires an entity to recognise, ~~or~~ and disclose information about, certain contingent particular non-financial liabilities. In the context of a multi-employer plan, an contingent additional non-financial liability may arise from, for example:~~

~~(a) actuarial losses relating to other participating entities because each entity that participates in a multi-employer plan shares in the actuarial risks of every other participating entity; or~~

~~(b) any responsibility under the terms of a plan to finance any shortfall in the plan if other entities cease to participate.~~

52 **An entity shall account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices. Informal practices give rise to a constructive obligation where when the entity has no realistic alternative but little, if any, discretion to avoid paying employee benefits and the employees can reasonably rely on the entity to pay those benefits. An example of a constructive obligation is where when a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.**

69 Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words, they are not vested). Employee service before the vesting date gives rise to an constructive obligation because, at each successive balance sheet date, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. In measuring its defined benefit obligation, an entity considers the probability that some employees may not satisfy any vesting requirements. Similarly, although ~~certain~~ some post-employment benefits, for example, post-employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists.

104A ~~When, and only when, it is virtually certain that~~ **an entity has a right to be reimbursed by another party will reimburse for some or all of the expenditure that will be required to settle a defined benefit obligation, an entity shall it recognises its the right to reimbursement right as an separate asset if the reimbursement right can be measured reliably.** The entity shall measure the asset at fair value. In all other respects, an entity shall treat that asset in the same way as plan assets. **An entity shall not offset against the defined benefit obligation the amount recognised for the reimbursement right.** In the income statement, the expense relating to a defined benefit plan may be presented net of the ~~amount recognised for a~~ **income resulting from the reimbursement right.**

- 104C When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. Paragraph 104A deals with such cases: the entity recognises its right to reimbursement under the insurance policy as an separate asset, rather than as a deduction in determining the defined benefit liability recognised ~~under in accordance with~~ paragraph 54; in all other respects, the entity treats that asset in the same way as plan assets. In particular, the defined benefit liability recognised ~~under in accordance with~~ paragraph 54 is increased (reduced) to the extent that net cumulative actuarial gains (losses) on the defined benefit obligation and on the related reimbursement right remain unrecognised ~~under in accordance with~~ paragraphs 92 and 93. Paragraph 120A(f)(iv) requires the entity to disclose a brief description of the link between the reimbursement right and the related obligation.
- A14 In FRS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, paragraph 11 is amended as follows.
- 11 Once a government grant is recognised, any related ~~contingent liability or contingent asset~~ non-financial liability is ~~treated~~ recognised in accordance with FRS 37 *~~Provisions, Contingent Liabilities and Contingent Assets~~ Non-financial Liabilities*.
- A15 In FRS 21 *The Effects of Changes in Foreign Exchange Rates*, 'provisions' in paragraph 16 is amended to 'liabilities'.
- A16 In FRS 28 *Investments in Associates*, paragraph 40 is amended as follows.
- 40 In accordance with FRS 37 *~~Provisions, Contingent Liabilities and Contingent Assets~~ Non-financial Liabilities*, the investor shall disclose details of:**
- (a) ~~its share of the contingent liabilities~~ any non-financial liability of an associate incurred jointly with other investors that, because of extremely rare circumstances, has not been recognised; and
- (b) ~~those contingent liabilities~~ any non-financial liability that arises because the investor is severally liable for all or part of the liabilities of the associate.
- A17 No consequential amendments are proposed to *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* because it was expected to issue in the near future a new Standard, based on ED 7 *Financial Instruments: Disclosures*.
- A18 In FRS 31 *Interests in Joint Ventures*, paragraph 54 is amended as follows.
- 54 A venturer shall disclose details of the aggregate amount of the following contingent liabilities non-financial liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities non-financial liabilities:**
- (a) ~~any contingent liabilities~~ non-financial liability that the venturer has incurred in relation to its interests in joint ventures ~~and its share in each of the contingent liabilities that have been incurred jointly with other venturers~~;

- (b) ~~its share of the contingent liabilities~~ any non-financial liability of the joint ventures themselves for which it is contingently liable that they have, because of extremely rare circumstances, not recognised; and
- (c) ~~those contingent liabilities~~ any non-financial liability that arises because the venturer is contingently severally liable for the liabilities of the other venturers of a joint venture.

A19 In FRS 32 *Financial Instruments: Disclosure and Presentation*, paragraph 94(b) is amended as follows.

94(b) An entity shall disclose the carrying amount of financial assets it has pledged as collateral for liabilities, the carrying amount of financial assets pledged as collateral for contingent liabilities and conditional obligations, and (consistently with paragraphs 60(a) and 63(g)) any material terms and conditions relating to assets pledged as collateral.

A20 FRS 34 *Interim Financial Reporting* is amended as described below.

In the Standard, paragraphs 16 and 17 are amended as follows.

16 An entity shall include the following information, as a minimum, in the notes to its interim financial statements, ~~if material and~~ if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis. However, the entity shall also disclose any events or transactions that are material to an understanding of the current interim period:

...

- (j) ~~changes in contingent liabilities or contingent assets since the last annual balance sheet date~~ in any unrecognised non-financial liabilities.

17 Examples of the kinds of disclosures that are required by paragraph 16 are set out below. Individual Standards and Interpretations provide guidance regarding disclosures for many of these items:

...

- (c) ~~the reversal of any provisions for the costs of restructuring;~~ [deleted]

...

In Appendix B, the heading above paragraph B3, and paragraphs B3, B4 and B6 are amended as follows.

Provisions Non-financial liabilities

B3 A ~~provision non-financial liability~~ is recognised when ~~an entity has no realistic alternative but to make a transfer of economic benefits as a result of an event that has created a legal or constructive obligation~~ the definition of a liability has been satisfied and the non-financial liability can be measured reliably. The carrying amount of the ~~obligation~~ non-financial liability is adjusted upward ~~or~~

~~downward, with a corresponding loss or gain recognised in the income statement, if the entity's best estimate of the amount of the obligation changes subsequently to reflect the current amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party.~~

- B4 This Standard requires ~~that~~ an entity to apply the same criteria for recognising and measuring a ~~provision~~ non-financial liability at an interim date as it would at the end of its financial year. The existence or non-existence of an obligation to transfer benefits is not a function of the length of the reporting period. It is a question of fact.
- B6 A bonus is anticipated for interim reporting purposes ~~if, and only if,~~ (a) the bonus is a legal obligation or past practice would make the bonus a constructive obligation ~~for which that~~ the entity has ~~no realistic alternative but to make the payments~~ little, if any, discretion to avoid paying, and (b) a reliable estimate of the obligation can be made. FRS 19 *Employee Benefits* provides guidance.

In Appendix C, paragraphs C3 and C6 are amended as follows.

- C3 ~~Provisions~~ **Non-financial liabilities:** Determination of the appropriate amount of a ~~provision~~ non-financial liability (such as a ~~provision~~ liability for warranties, environmental costs, and site restoration costs) may be complex and often costly and time-consuming. Entities sometimes engage outside experts to assist in the annual calculations. Making similar estimates at interim dates often entails updating of the prior annual ~~provision~~ liability rather than ~~the~~ engaging of outside experts to do a new calculation.
- C6 **Contingencies:** The measurement of ~~contingencies~~ some liabilities (and assets) is required to reflect uncertainty about the occurrence or non-occurrence of one or more related uncertain future events. Therefore, it may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to ~~contingencies~~ these liabilities (and assets). Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may ~~or may not~~ also be needed at interim dates.

A21 FRS 36 *Impairment of Assets* is amended as described below.

In paragraph 43(b), 'provisions' is amended to 'non-financial liabilities'.

Paragraphs 44-47 are amended as follows.

44 Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

- (a) **a future restructuring to for which an entity is not yet committed a liability has not been incurred;** or

...

45 Because future cash flows are estimated for the asset in its current condition, value in use does not reflect:

- (a) future cash outflows or related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future

restructuring ~~to~~ for which an entity ~~is not yet committed~~ a liability has not been incurred; or

...

- 46 ~~A restructuring is a programme that is planned and controlled by management and materially changes either the scope of the business undertaken by an entity or the manner in which the business is conducted. FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* Non-financial Liabilities contains guidance clarifying when an entity is committed to~~ specifies when an entity recognises a liability for a cost associated with a restructuring.
- 47 When an entity ~~becomes committed to~~ incurs a liability for a cost associated with a restructuring, some assets are likely to be affected by this restructuring. Once the entity ~~is committed to~~ incurs a liability for a cost associated with the restructuring:
- (a) its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts approved by management); and
 - (b) its estimates of future cash outflows for the cost associated with the restructuring are included reflected in the measurement of a restructuring provision non-financial liability in accordance with FRS 37.

Illustrative Example 5 illustrates the effect of a future restructuring on a value in use calculation.

The example following paragraph 78 is amended as follows.

Example

A company operates a mine in a country ~~where~~ in which legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A ~~provision~~ non-financial liability for the ~~costs~~ obligation to replace the overburden was recognised as soon as the overburden was removed. The amount ~~provided was recognised~~ of the liability initially recognised was included as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the ~~provision~~ liability for restoration costs is CU500,* ~~which is equal to the present value of the restoration costs.~~

continued...

The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around CU800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately CU1,200, excluding restoration costs. The carrying amount of the mine is CU1,000.

The cash-generating unit's fair value less costs to sell is CU800. This amount considers restoration costs ~~that have for which a liability has already been provided for~~ recognised. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be CU700 (CU1,200 less CU500). The carrying amount of the cash-generating unit is CU500, which is the carrying amount of the mine (CU1,000) less the carrying amount of the ~~provision~~ liability for restoration costs (CU500). Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount.

* In this Standard, monetary amounts are denominated in 'currency units' (CU).

In paragraph 79, 'other provisions' is amended to 'liabilities'.

In the Illustrative Examples, Example 5 is amended as follows.

Example 5 Treatment of a future restructuring

In this example, tax effects are ignored.

Background

...

IE46 Management-approved budgets reflect that:

(a) at the end of 20X3, ~~the number of employees at the plant will be restructured~~ reduced at an estimated cost (for termination benefits) of CU100. ~~Since~~ Because K is not yet committed to the restructuring ~~has not yet incurred a liability to provide termination benefits,~~ a ~~provision liability~~ liability has not been recognised ~~at the end of 20X0 for the future restructuring costs.~~

(b) there will be future benefits from this restructuring in the form of reduced future cash outflows.

IE47 At the end of 20X2, K ~~becomes committed to the restructuring~~ recognises a liability to provide termination benefits in accordance with FRS 19 Employee Benefits. The costs are still estimated to be CU100 ~~and a provision is recognised accordingly.~~ The plant's estimated future cash flows reflected in the most recent management-approved budgets are ~~given~~ set out in paragraph IE51 and a ~~the~~ current discount rate is the same as at the end of 20X0.

IE48 At the end of 20X3, actual ~~restructuring~~ termination benefit costs of CU100 are ~~incurred and~~ paid. Again, the plant's estimated future cash flows reflected in the most recent management-approved budgets and a current discount rate are the same as those estimated at the end of 20X2.

At the end of 20X0

Schedule 1. Calculation of the plant's value in use at the end of 20X0

Year	Future cash flows	Discounted at 14%
	CU	CU
20X1	300	263
20X2	280	215
20X3	420 ¹	283
20X4	520 ²	308
20X5	350 ²	182
20X6	420 ²	191
20X7	480 ²	192
20X8	480 ²	168
20X9	460 ²	141
20X10	400 ²	108
Value in use		<u>2,051</u>

¹ Excludes estimated ~~restructuring~~ costs of termination benefits reflected in management budgets.

² Excludes estimated benefits reflected in management budgets expected from the ~~restructuring~~ reflected in management budgets reduction in the number of employees.

...

At the end of 20X2

IE51 The entity ~~is now committed to the restructuring~~ has now incurred a liability to provide termination benefits. Therefore, in determining the plant's value in use, the benefits expected from the restructuring are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. In accordance with paragraphs 110 and 111 of FRS 36, the recoverable amount of the plant is re-determined at the end of 20X2.

Schedule 3. Calculation of the plant's value in use at the end of 20X2

<i>Year</i>	<i>Future cash flows</i>	<i>Discounted at 14%</i>
	CU	CU
20X3	420 ¹	368
20X4	570 ²	439
20X5	380 ²	256
20X6	450 ²	266
20X7	510 ²	265
20X8	510 ²	232
20X9	480 ²	192
20X10	410 ²	144
Value in use		<u>2,162</u>

1 Excludes estimated ~~restructuring costs~~ of termination benefits because a liability has ~~already~~ been recognised.

2 Includes estimated benefits reflected in management budgets expected from the ~~restructuring~~ reflected in management budgets reduction in the number of employees.

...

At the end of 20X3

IE53 There is a cash outflow of CU100 when the ~~restructuring costs~~ termination benefits are paid. Even though a cash outflow has taken place, there is no change in the estimated future cash flows used to determine value in use at the end of 20X2. Therefore, the plant's recoverable amount is not calculated at the end of 20X3.

...

A22 FRS 38 *Intangible Assets* is amended as described below.

After paragraph 17 a new heading and paragraphs 17A and 17B are added, as follows.

Contingencies

17A In some cases, an entity has an intangible asset even though the amount of the future economic benefits embodied in that asset is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In such cases, an entity has two rights as a result of a past event, an unconditional right and a conditional right. The intangible asset arises from the unconditional right, but the conditional right is reflected in the measurement of the intangible asset.

17B An example of such an intangible asset is a product warranty. The entity's asset arises from its unconditional right to warranty coverage for the duration of the warranty contract rather than from its conditional right to have its product repaired or replaced if it develops a fault. Similarly, an entity that is pursuing a legal claim has an intangible asset arising from the actions it performed to get to the point of pursuing its claim. Any amounts that the entity expects to receive as a result of pursuing a legal claim are a conditional right, because the right to receive them is conditional on a future event (e.g. the judgement of the court).

A23 FRS 39 *Financial Instruments: Recognition and Measurement* is amended as described below.

Paragraph 2 is amended as follows.

2 This Standard shall be applied by all entities to all types of financial instruments except:

...

(h) except as described in paragraph 4, loan commitments that cannot be settled net in cash or another financial instrument. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction). An issuer of a commitment to provide a loan at a below-market interest rate shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under in accordance with FRS 37 *Non-financial Liabilities* and (ii) the amount initially recognised less, ~~where~~ when appropriate, cumulative amortisation recognised in accordance with FRS 18 *Revenue*. An issuer of loan commitments shall apply FRS 37 to other loan commitments that are not within the scope of this Standard if they are onerous. (FRS 37 explains when a contract is onerous.) Loan

commitments are subject to the derecognition provisions of this Standard (see paragraphs 15-42 and Appendix A paragraphs AG36-AG63).

...

- (j) rights to payments to reimburse the entity for expenditure it is some or all of the economic benefits that will be required to make to settle a non-financial liability that it recognises as a provision recognised in accordance with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it the entity recognised a provision non-financial liability in accordance with FRS 37.

In the Application Guidance, paragraph AG86 is amended as follows.

AG86 The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss ~~equal to the best estimate within that~~ reflects the range of possible outcomes weighted by their associated probabilities * taking into account all relevant information about conditions existing at the balance sheet date that is available before the financial statements are issued ~~about conditions existing at the balance sheet date.~~

* Example 17 in FRS 37, paragraph 39 contains guidance on how to determine ~~the best an~~ an estimate in when there is a range of possible outcomes.

A24 In INT FRS 101 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, paragraph 3 is amended as follows.

3 This Interpretation addresses how the effect of the following events that change the measurement of an existing decommissioning, restoration or similar liability should be accounted for:

...

- (b) a change in the current market-based discount rate as ~~defined~~ described in paragraph 47 ~~38~~ of FRS 37 (this includes changes in the time value of money and the risks specific to the liability); and

...

A25 In INT FRS 105 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*, paragraphs 9, 10, 12 and 13 are amended as follows.

9 If a contributor does not have control, joint control or significant influence over the fund, the contributor shall recognise the right to receive reimbursement from the fund as a reimbursement right in accordance with FRS 37. This reimbursement right shall be measured at the lower of:

...

10 When a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor or if the value of the investment assets held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations, this obligation is a contingent liability that is within the scope of FRS 37. Therefore, the contributor

shall recognise a liability only if it is probable that additional contributions will be made unless it cannot be measured reliably. The measurement of the liability reflects the probability that the contributor will have to make additional contributions and their amount and timing.

- 12 When a contributor has an obligation to make potential additional contributions that is not recognised as a liability (see paragraph 10), it shall make the disclosures required by paragraphs ~~86~~ 67 and 68 of FRS 37, unless the liability cannot be measured reliably, in which case it shall make the disclosures required by paragraph 69 of FRS 37.
- 13 When a contributor accounts for its interest in the fund in accordance with paragraph 9, it shall make the disclosures required by paragraph ~~85(e)~~ 68(d) of FRS 37.

Illustrative Examples

These examples accompany, but are not part of, [draft] FRS 37.

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Example 16	Self-insurance
Example 17	Measurement of a decommissioning obligation
Example 18	Disclosure of a warranty obligation
Example 19	Disclosure of a decommissioning obligation
Example 20	Disclosure exemption

All the entities in the examples have 31 December year-ends. In all cases, it is assumed that the non-financial liability can be measured reliably. In some examples, the circumstances described may have resulted in impairment of assets—this aspect is not dealt with in the examples.

Example 1: Disputed lawsuit

After a wedding in 20X0, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings have been started seeking damages from the entity. However, the entity disputes liability because it does not believe that its food was harmful. Up to the date of authorisation for issue of the financial statements for the year to 31 December 20X0, the entity's lawyers advise that it is unlikely that the entity will be found liable.

Present obligation as a result of a past event – The past event is the start of legal proceedings. Up to this point, the entity was not aware that it had sold harmful food. Even at the time the entity authorises for issue its financial statements, it disputes that it sold harmful food. Nonetheless, the start of legal proceedings obliges the entity to stand ready to perform as the court directs and hence the entity has a present obligation.

Conclusion – A non-financial liability is recognised.

A note about measurement – The objective in measuring the liability is to estimate the amount that the entity would rationally pay to settle or to transfer the obligation *on* the balance sheet date. Even if the entity expects that it will not be found liable, no other party would assume the obligation on the balance sheet date without being compensated by the entity. This is because of the costs involved in defending the lawsuit and the risk of an adverse outcome.

In measuring the liability at 31 December 20X0, the entity considers factors such as:

- the possible outcomes of the lawsuit;
- the cash flows associated with those outcomes (including the costs associated with the lawsuit);
- the timing of the cash flows;
- the probabilities of those outcomes; and
- the risks and uncertainties associated with the obligation (i.e. the range or variability of the possible outcomes).

The last factor is sometimes referred to as a 'risk adjustment' and it is the amount that a third party would demand for bearing the uncertainty and unforeseeable circumstances inherent in the obligation concerning the amount and timing of any cash flows.

Example 17 gives guidance on the use of an expected cash flow approach, in which multiple cash flow scenarios are weighted by their respective probabilities, as the basis for measuring a liability.

Example 2: Potential lawsuit

Shortly before 31 December 20X0, a patient dies in a hospital as a result of a mistake made during an operation. The hospital is aware that a mistake occurred. In these circumstances, the hospital's past experience and lawyers' advice indicate that it is highly likely that the patient's

relatives will start legal proceedings and, if the matter comes to court, that the hospital will be found guilty of negligence.

At the time that the financial statements are authorised for issue in early 20X1, the hospital has not received notice of legal proceedings against it.

Present obligation as a result of a past event – The past event is the operation in which negligence occurred.

Conclusion – A non-financial liability is recognised.

A note about measurement – Measurement of the liability reflects the likelihood that the hospital will be required to pay compensation because of the mistake, and the amount and timing of that compensation.

Example 3A: Contaminated land – legislation substantively enacted

An entity in the oil industry causes contamination, but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates previously had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. The government, however, is considering introducing new legislation that will require contamination, including prior contamination, to be cleaned up. By 31 December 20X0, the new law is substantively enacted.

Present obligation as a result of a past event – The past event is the substantive enactment of legislation requiring the contaminated land to be cleaned up. Therefore, the entity has a present obligation to clean up its contamination.

Conclusion – A non-financial liability is recognised for the clean-up obligation.

A note about measurement – Measurement of the liability on 31 December 20X0 reflects uncertainty about the timing and amount of the expenditure required to clean up the contamination.

Example 3B: Contaminated land and constructive obligation

An entity in the oil industry causes contamination and operates in a country in which there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy.

Present obligation as a result of a past event – The past event is the contamination of the land, which gives rise to a present constructive obligation. This is because:

- by publishing its environmental policy the entity has publicly indicated that it will accept the responsibility to clean up its contamination.
- by publishing that policy and honouring it in the past, other parties can reasonably rely on the entity to clean up its contamination.
- other parties will suffer harm if the entity does not clean up its contamination.

Conclusion – A non-financial liability is recognised for the clean-up obligation.

Example 4A: Extended product warranty

A manufacturer sells extended product warranties to purchasers of its product. Under the terms of the warranty contract the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale.

Present obligation as a result of a past event – The past event is the sale of the warranty, which gives rise to a present obligation to provide a service for the duration of the warranty (i.e. to stand ready to honour warranty claims).

Conclusion – A non-financial liability is recognised.

A note about measurement – In the absence of market evidence to determine the amount needed to settle or transfer the warranty obligation on the balance sheet date, the entity considers factors such as:

- the estimated number of claims that will arise from warranties sold on or before the balance sheet date. In estimating the number of claims, the entity may develop a number of different scenarios of possible claims, weighting each by its respective probability.
- the cash flows associated with meeting the estimated number of claims.
- the timing of the cash flows.
- the risks and uncertainties associated with the obligation (i.e. the range or variability of the possible outcomes).

When an entity issues product warranties in exchange for a fee, revenue is recognised in accordance with FRS 18 *Revenue*.

Example 4B: Extended product warranty – no constructive obligation

The facts are the same as Example 4A. However, in addition, in this example the entity frequently repairs or replaces the product if manufacturing defects become apparent in the fourth and fifth year after the date of sale in order to maintain customer goodwill. The entity does not make this practice widely known. In addition, the entity carefully scrutinises any claims it receives in the fourth and fifth year following the date of sale to assess the costs of repairing or replacing the product against the potential damage to customer goodwill.

Present obligation as a result of a past event – There is no constructive obligation at the date of sale to provide warranty coverage in the fourth and fifth years following the date of sale. Although the entity frequently repairs products after the contractual warranty period has expired, the entity has not indicated to its customers that this is its general practice. In addition the entity retains discretion about whether it will meet claims after expiry of the warranty period, and hence customers cannot reasonably rely on the entity to meet such claims.

Conclusion – No liability is recognised for warranty coverage after expiry of the warranty period.

Example 5: Single guarantee

On 31 December 20X0 Entity A gives a guarantee of specified borrowings of Entity B, whose financial condition at that time is sound. During 20X1 the financial condition of Entity B deteriorates and at 30 June 20X1 Entity B files for protection from its creditors.

This contract meets the definition of an insurance contract in FRS 104 *Insurance Contracts*. FRS 104 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. FRS 104 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that FRS 104 permits.

Present obligation as a result of a past event – The past event is issuing the guarantee. This gives rise to a present obligation to provide a service for the duration of the guarantee (i.e. to stand ready to repay the borrowing of Entity B).

Conclusion – A liability is recognised.

A note about measurement – The guarantee is initially recognised at fair value. Subsequently, it is measured at the higher of (a) the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party, and (b) the amount initially recognised in accordance with FRS 39 *Financial Instruments: Recognition and Measurement* less, when appropriate, cumulative amortization recognised in accordance with FRS 18.

Example 6: Offshore oilfield

An entity operates an offshore oilfield. Its licensing agreement for the oilfield requires the entity to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10 per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed, but no oil has been extracted.

Present obligation as a result of a past event – The construction of the oil rig creates a present obligation under the terms of the licence to remove the rig and restore the seabed. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

Conclusion – A non-financial liability is recognised for the entity's obligation to remove the oil rig and restore the damage caused by building it.

A note about measurement – The measurement of the liability at the balance sheet date reflects that only 90 per cent of the eventual costs of removing the oil rig and restoring the seabed are attributable to building the oil rig. The obligation to restore the damage that arises through the extraction of oil is recognised as it is incurred, i.e. when the oil is extracted.

The amount of the liability recognised initially is included in the cost of the oil rig in accordance with FRS 16 *Property, Plant and Equipment*. Subsequent changes in the measurement of the liability are recognised in accordance with INT FRS 101 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

Example 7: Contingent asbestos removal obligation

An entity acquires a factory that contains asbestos. After the acquisition date, new laws come into effect that require the entity to handle and dispose of the asbestos in a special way if the factory undergoes major renovation or is demolished. Otherwise, the entity is not required to remove the asbestos from the factory. The entity has several options to retire the factory in the future including demolishing, selling, or abandoning it.

Present obligation as a result of a past event – Although performance of the removal of the asbestos is conditional on the major renovation or demolition of the factory, enactment of the law creates a present obligation for the entity to remove and dispose of asbestos in a special way. Although the entity may decide to abandon the factory, and thereby defer settlement of the obligation for the foreseeable future, the ability to abandon the factory, and thereby defer settlement, does not relieve the entity of the obligation. The asbestos will eventually need to be removed and disposed of in a special way. In addition, the ability of the entity to sell the factory before disposal of the asbestos does not relieve the entity of its obligation. The sale of the asset would transfer the obligation to another entity and that transfer would affect the selling price.

Conclusion – A non-financial liability for the obligation to remove the asbestos is recognised when the law is enacted.

Example 8: Joint and several liability

In 20X0, Entity A and Entity B enter into a joint arrangement to extract minerals from land owned by Entity C. As part of the agreement with Entity C, Entity A and Entity B are jointly and severally liable for the obligation to restore Entity C's land at the completion of extraction (expected to be in 20X9). The agreement between Entity A and Entity B specifies that Entity B will restore the land. During 20X5, the financial condition of Entity B deteriorates, raising the possibility that Entity A will be required to restore the land in 20X9.

Present obligation as a result of a past event – The agreement between Entity A and Entity C gives rise to a present obligation for Entity A (i.e. to stand ready to restore the land). Although Entity B is primarily responsible for restoring the land, Entity C has a right to require Entity A to restore the land because of the joint and several nature of the agreement.

Conclusion – Entity A recognises a non-financial liability.

A note about measurement – In measuring its liability, Entity A reflects the likelihood that it, rather than Entity B, will be required to restore the land. Therefore, the liability may not initially warrant recognition on the basis of materiality. When Entity A recognises a liability, it also considers recognising an asset for its right to reimbursement from Entity B as a result of the agreement specifying that Entity B is responsible for restoring the land.

Example 9: Refunds policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past event – The past event is the sale of the product, which gives rise to a present constructive obligation to stand ready to make refunds to dissatisfied customers. This is because:

- by making its policy of refunding purchases generally known, the entity has publicly indicated that it will refund customers.
- by making its policy generally known, customers can reasonably rely on the entity to refund their purchases.
- customers will suffer harm if the entity does not refund their purchases in accordance with its policy.

Conclusion – A non-financial liability is recognised for the entity’s obligation to stand ready to provide refunds.

A note about measurement – Measurement of the liability reflects the likelihood of the entity being required to refund purchases made by customers before the balance sheet date and the timing and amount of those refunds.

Any revenue received from the transaction to which the refund obligation relates is accounted for in accordance with FRS 18.

Example 10A: New legislation 1

An entity sells electrical products in a country whose government is considering introducing new environmental legislation. If enacted, the legislation would require the entity to take back its products from customers for recycling and disposal. The legislation is expected to be retrospective. Hence, customers are expected to be able to return products for disposal that were sold before enactment of the legislation now being considered.

At the balance sheet date, the legislation has not been substantively enacted.

Present obligation as a result of a past event – At the balance sheet date there is no present obligation (unless the entity by its own actions created a constructive obligation before the law was substantively enacted). Until the law is substantively enacted, the entity does not have a present obligation with respect to that law.

Conclusion – No liability is recognised.

Example 10B: New legislation 2

The facts are the same as in example 10A. However, in this example the entity had previously entered into a contract with a counterparty. In accordance with the terms of the contract, the entity is indemnified by the counterparty against the costs of recycling and disposing of its electrical products sold before the date on which it entered into the contract.

Present obligation as a result of a past event – At the balance sheet date, the counterparty has a present obligation as a result of entering into the contract.

Conclusion – The counterparty recognises a liability.

This is an example of an insurance contract, which is outside the scope of FRS 37. However, it is included for illustrative purposes.

Example 11: Closure of a division

On 12 December 20X0 the management of an entity approved a detailed plan for closing a division. The plan requires termination of (a) various contracts and (b) the employment of the division's employees. On 31 December 20X0 the entity issued a press release announcing its decision to close the division.

Before the entity took the decision to close the division, none of the contracts was regarded as onerous.

On 31 January 20X1 the entity gave notice, under the terms of its contracts, to the relevant counterparties to terminate its contracts and on 1 March 20X1 the entity began to terminate the employment of its employees.

(a) At the balance sheet date of 31 December 20X0

Present obligation as a result of a past event – There has been no past event giving rise to a present obligation to restructure. The public announcement of the entity's intention to close the division does not, by itself, create a present obligation.

Conclusion – No liability is recognised.

(b) At 31 January 20X1

Present obligation as a result of a past event – The event that makes the contracts onerous is giving notice to terminate them.

Conclusion – A liability is recognised at 31 January 20X1 for any contract termination costs.

The entity recognises termination benefits in accordance with the requirements of FRS 19 *Employee Benefits*.

Example 12: Onerous contract

An entity operates profitably from a factory it leases under an operating lease. During December 20X0 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years and it cannot be cancelled. Since the lease started, lease rates on commercial buildings in the entity's location have declined.

Present obligation as a result of a past event – The lease contract for the old factory gave rise to a legal obligation. The contract is now onerous because the entity does not expect to receive economic benefits from the factory and the contract gives rise to unavoidable costs (i.e. the remaining lease rentals reduced by the estimated sublease rentals that could reasonably be obtained for the factory). The past event that makes this lease contract onerous is the entity vacating the old factory.

Conclusion – A liability is recognised.

A note about measurement – Measurement of the liability is by reference to the unavoidable lease payments reduced by the estimated sublease rentals that the entity could reasonably obtain, even if the entity does not intend to enter into a sublease.

Example 13: Legal requirement to install smoke filters

Under new legislation, an entity is required to install smoke filters in its factories by 30 June 20X1, otherwise it will incur penalties. At 31 December 20X1 the entity has not installed the smoke filters but has continued to operate the factories.

(a) At the balance sheet date of 31 December 20X0

Present obligation as a result of a past event – There is no present obligation because there is no past event either for the costs of installing smoke filters or for penalties under the legislation. This is because (a) the entity has the discretion to avoid installing the smoke filters and (b) at 31 December 20X0 the entity is in compliance with the legislation.

Conclusion – No liability is recognised for the cost of installing the smoke filters.

(b) At the balance sheet date of 31 December 20X1

Present obligation as a result of a past event – There is no obligation for the costs of installing smoke filters because a past event committing the entity to install the filters has not occurred. The entity can stop using the factory and therefore avoid installing the filters. However, the failure to comply with legislation is a past event giving rise to a present obligation, because the entity will be obliged to pay the penalties imposed under the legislation for non-compliant operation of the factory.

Conclusion – No liability is recognised for the costs of installing smoke filters. However, a non-financial liability is recognised for the obligation to pay fines and penalties.

Example 14: Staff retraining as a result of changes in the income tax system

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

Present obligation as a result of a past event – There is no obligation because no past event (i.e. retraining) has taken place. This is because the entity has the discretion to avoid retraining its workforce.

Conclusion – No liability is recognised.

Example 15: Repairs and maintenance

Some items of property, plant and equipment require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major parts. FRS 16 gives guidance on allocating the amount recognised in respect of an item of property, plant and equipment to its significant parts.

Example 15A: Refurbishment costs – no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past event – There is no present obligation.

The cost of replacing the lining is not recognised as a liability because, at the balance sheet date, no obligation to replace the lining exists independently of the entity's future actions—even the intention to incur the expenditure depends on the entity deciding to continue operating the furnace or to replace the lining. Instead of a liability being recognised, the depreciation of the lining takes account of its consumption, i.e. it is depreciated over five years. The costs of replacing the lining then incurred are recognised as a part of the carrying amount of the furnace with the consumption of each new lining shown by depreciation over the subsequent five years.

Conclusion – No liability is recognised.

Example 15B: Refurbishment costs – legislative requirement

An airline is required by law to overhaul its aircraft once every three years as a condition of continuing to operate them.

Present obligation as a result of a past event – There is no present obligation.

The costs of overhauling aircraft are not recognised as a liability for the same reasons the cost of replacing the lining is not recognised as a liability in example 15A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions. Instead of a liability being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e. an amount equivalent to the expected maintenance costs is depreciated over three years.

Conclusion – No liability is recognised.

Example 16: Self-insurance

An entity that operates a chain of retail outlets reviews its insurance arrangements for its liability in respect of accidents sustained by customers. The entity is not required to have public liability insurance coverage and decides to 'self insure', i.e. to retain the risk of claims from customers.

Present obligation as a result of a past event – There is no present obligation with respect to uninsured accidents that may arise in the future.

Conclusion – No liability is recognised for uninsured accidents that may arise in the future. A liability is recognised only for accidents that have occurred before the balance sheet date. The entity may have to make an estimate of accidents that have occurred but have not yet been reported to it.

Example 17: Measurement of a decommissioning obligation

The purpose of the example is to illustrate one way in which the requirements in paragraphs 29-42 may be applied.

An entity places an offshore oil rig into service. The entity is required by law to dismantle and remove the rig at the end of its useful life, which is estimated to be 10 years.

The entity estimates a range of cash flows (that include the effects of inflation) needed to dismantle and remove the rig, and assigns probability assessments to the range as follows.

Estimated cash flows and associated probabilities

Cash flow estimate	Probability assessment	Expected cash flows
CU	%	CU
200,000	25	50,000
225,000	50	112,500
275,000	25	<u>68,750</u>
Expected cash flow		<u>231,250</u>

The entity estimates that the cash flows should be increased by 5 per cent to reflect the uncertainties and unforeseeable circumstances inherent in the obligation (for example, the risk that removal of the rig may cost more than expected). This risk adjustment may be determined by considering factors such as the range of variability of the possible outcomes and the amount that a third party would typically demand for bearing the uncertainty and unforeseeable circumstances inherent in 'locking in' today's price for cash flows that are expected to occur in 10 years.

The entity estimates that the discount rate that reflects current market assessments of the time value of money is 6 per cent (risks specific to the liability are included by adjusting the above cash flow estimate).

The entity estimates the initial measurement of the obligation as follows:

	CU	CU
Expected cash flows	231,250	
Risk adjustment	<u>11,563</u>	
		<u>242,813</u>
Present value using rate of 6 per cent for 10 years		<u>135,586</u>

Example 18: Disclosure of a warranty obligation

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a liability of CU60,000 has been recognised. The following information is disclosed:

A liability of CU60,000 has been recognised for expected warranty claims on products sold during the last three years. It is expected that the majority of claims will occur in the next year, and all will occur within two years of the balance sheet date.

Example 19: Disclosure of a decommissioning obligation

In 2000 an entity involved in nuclear power generation recognises a liability for decommissioning costs of CU300 million. The liability is based on the decommissioning costs that are expected to be incurred, adjusted for risk, using existing technology. The costs reflect current prices and are discounted using a real discount rate of 2 per cent. The other significant assumption is that there is a 90 per cent likelihood that the decommissioning will take place in 60-70 years and a 10 per cent likelihood that it will not take place until 100-110 years. The following information is disclosed:

A liability of CU300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2060 and 2070. However, there is a possibility that decommissioning will not take place until 2100-2110. The likelihood of these different outcomes is reflected in the measurement of the liability. The liability has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2 per cent.

Example 20: Disclosure exemption

An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of CU100 million. The entity recognises a non-financial liability for the amount that it would rationally pay to settle or transfer the obligation, but discloses none of the information required by paragraph 68 of the [draft] Standard because this information can be expected to prejudice seriously its position. The following information is disclosed:

The company is in a dispute with a competitor. This has resulted in litigation against the company alleging that it has infringed patents and seeking damages of CU100 million. The information usually required by [draft] FRS 37 Non-financial Liabilities is not disclosed because it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.

Table of Concordance

This table shows how the contents of FRS 37 and the Exposure Draft correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

FRS 37 paragraph	Exposure Draft paragraph	FRS 37 paragraph	Exposure Draft paragraph
Objective	1	36	29
1	2	37	None
2	None	38	32
3	3	39	31
4	None	40	31
5	4	41	34
6	7	42	35
7	None	43	36
8	8	44	37
9	None	45	38
10	10	46	39
11	None	47	38
12	None	48	41
13	None	49	42
14	11	50	42
15	None	51	None
16	None	52	None
17	13	53	46
18	None	54	50
19	17, 18	55	47
20	19	56	49
21	20	57	49
22	21	58	None
23	None	59	43
24	None	60	45
25	27	61	None
26	28	62	None
27-30	22-26	63	52
31-35	FRS 38 17A & 17B	64	53

FRS 37 paragraph	Exposure Draft paragraph	FRS 37 paragraph	Exposure Draft paragraph
65	54	87	70
66	55	88	None
67	56	89	None
68	58	90	None
69	59	91	None
70	60	92	71
71	61	93	72
72	None	95	72
73	None	Example 1	4A
74	None	Example 2	3
75	66	Example 3	6
76	None	Example 4	9
77	None	Example 5	11
78	None	Example 6	13
79	None	Example 7	14
80	None	Example 8	12
81	65	Example 9	5
82	None	Example 10	1
83	None	Example 11	15
84	67, 68	Disclosure Example 1	18
85	68	Disclosure Example 2	19
86	69	Disclosure Example 3	20

PROPOSED AMENDMENTS TO
FRS 19
EMPLOYEE BENEFITS

INVITATION TO COMMENT

The CCDG would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale, and, when applicable, provide a suggestion for alternative wording.

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?

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?

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?

SUMMARY OF MAIN CHANGES (FRS 19)

The following main changes are proposed:

Definition of termination benefits

- The definition of termination benefits in FRS 19 includes employee benefits that are payable as a result of an employee's decision to accept voluntary redundancy in exchange for those benefits. The Exposure Draft proposes that:
 - the definition should be amended to clarify that benefits that are payable in exchange for an employee's decision to accept voluntary redundancy are termination benefits only if they are offered for a short period.
 - other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits.

Recognition

- FRS 19 states that termination benefits should be recognised when the entity is demonstrably committed either to terminating the employment of employees before the normal retirement date or to providing termination benefits as a result of an offer made in order to encourage voluntary redundancy. The Exposure Draft proposes that:
 - voluntary termination benefits should be recognised when employees accept the entity's offer of those benefits.
 - involuntary termination benefits should be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria, unless the involuntary termination benefits are provided in exchange for employees' future services (i.e. in substance they are a 'stay bonus'). In such cases, the liability for those benefits should be recognised over the future service period.

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OTHER AMENDMENTS TO THE STANDARD

PROPOSED AMENDMENTS TO FINANCIAL ACCOUNTING STANDARD 19

Employee Benefits

For ease of reference, paragraphs proposed to be amended are shown with new text underlined and deleted text struck through. Proposed new paragraphs are not underlined.

DEFINITIONS

Paragraph 7 is amended as follows.

7 The following terms are used in this Standard with the meanings specified:

...

Termination benefits are employee benefits ~~payable as a result of~~ provided in connection with the termination of an employee's employment. They may be either:

- (a) involuntary termination benefits, which are benefits provided as a result of an entity's decision to terminate an employee's employment before the normal retirement date; or
- (b) voluntary termination benefits, which are benefits offered for a short period in exchange for an employee's decision to accept voluntary redundancy termination of employment in exchange for those benefits.

The *minimum retention period* is the period of notice that an entity is required to provide to employees in advance of terminating their employment. The notice period may be specified by law, contract or union agreement, or may be implied as a result of customary business practice.

...

TERMINATION BENEFITS

Paragraph 132 is amended; paragraph 135 is moved, amended and renumbered as 133; paragraphs 134 and 135 are added; and paragraph 136 is moved and amended as follows.

- 132 This Standard deals with termination benefits separately from other employee benefits because, except as described in paragraphs 139 and 140, the event ~~which~~ that gives rise to an obligation is the termination of employment rather than employee service.
- ~~135~~133 ~~An entity may be committed, by legislation, by contractual or other agreements with employees or their representatives or by a constructive obligation based on business practice, custom or a desire to act equitably, to make payments (or provide other benefits) to employees when it terminates their employment. Such payments are termination benefits.~~ Termination benefits are typically lump-sum payments, but sometimes also include:
- (a) enhancement of retirement benefits or of other post-employment benefits, either indirectly through an employee benefit plan or directly; and
 - (b) salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity.
- 134 Involuntary termination benefits are often provided in accordance with the terms of an ongoing benefit plan. For example, they may be specified by statute, employment contract or union agreement, or may be implied as a result of the employer's past practice of providing similar benefits. In other cases, they are provided at the discretion of the entity and are incremental to what an employee would otherwise be entitled to, for example because the entity has no ongoing benefit plan or provides benefits in addition to those specified by an ongoing benefit plan.
- 135 Some entities offer benefits to encourage employees to accept voluntary termination of employment before normal retirement date. For the purpose of this [draft] Standard, such benefits are termination benefits only if they are offered for a short period. Other benefits offered to encourage employees to accept voluntary termination of employment (for example, those available under the terms of an ongoing benefit plan) are post-employment benefits because the benefits are payable in exchange for the employees' service.
- 136 Some employee benefits are payable provided regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits are described in some ~~countries~~ jurisdictions as termination indemnities, or termination gratuities, they are post-employment benefits, ~~rather than termination benefits and an entity accounts for them as post-employment benefits~~. Some entities provide a lower level of benefit for voluntary termination of employment at the request of the employee (in substance, a post-employment benefit) than for involuntary termination at the request of the entity. The additional benefit payable on involuntary termination of employment is a termination benefit.

Recognition

Paragraphs 133, 134, 137 and 138 are deleted and paragraphs 137-142 are added as follows.

- 137 An entity shall recognise a liability and expense for voluntary termination benefits when the employee accepts the entity's offer of those termination benefits.**
- 138 Except as specified in paragraph 139, an entity shall recognise a liability and expense for involuntary termination benefits when it has a plan of termination that it has communicated to the affected employees, and actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The plan shall:**
- (a) identify the number of employees whose employment is to be terminated, their job classifications or functions and their locations, and the expected completion date; and**
 - (b) establish the benefits that employees will receive upon termination of employment (including but not limited to cash payments) in sufficient detail to enable employees to determine the type and amount of benefits they will receive when their employment is terminated.**
- 139 If involuntary termination benefits are provided in exchange for employees' future services, an entity shall recognise the termination benefits as a liability and an expense over the period of the employees' future services (i.e. from the date specified in paragraph 138 to the date that employment is terminated).**
- 140 In some cases, involuntary termination benefits are provided in exchange for employees' future services. For the purpose of this [draft] Standard, this is the case if those benefits:
- (a) are incremental to what the employees would otherwise be entitled to receive (i.e. the benefits are not provided in accordance with the terms of an ongoing benefit plan);
 - (b) do not vest until the employment is terminated; and
 - (c) are provided to employees who will be retained beyond the minimum retention period.
- 141 In some cases, employers provide involuntary termination benefits that are expressed as an enhancement of the existing terms of an ongoing benefit plan. Examples are a doubling of benefits specified by employment legislation and an increase in retirement benefits to be provided through a post-employment benefit plan. If the termination benefits that are attributable to the enhancement of the ongoing benefit plan do not represent a change to the terms of the ongoing plan (and therefore would not apply to employees leaving service in the future) and satisfy the criteria in paragraph 140(b) and (c), they shall be recognised in accordance with paragraph 139.
- 142 When termination benefits are provided through a post-employment benefit plan, the liability and expense recognised initially include only the value of the additional benefits that arise from providing those termination benefits. Other changes in any defined benefit obligation for the post-employment benefit plan resulting from employees leaving employment at a date earlier than originally assumed should be recognised either as actuarial gains or losses or as a curtailment.

Measurement

Paragraphs 139 and 140 are amended and renumbered as 143 and 145, and paragraph 144 and the illustrative example are added as follows.

~~139~~**143** ~~Where~~ When termination benefits ~~fall~~ are due more than 12 months after the balance sheet date, ~~they~~ an entity shall be discounted ~~them~~ using the discount rate specified in paragraph 78 and shall subsequently follow the recognition and measurement requirements for post-employment benefits.

144 Accordingly, when termination benefits are provided through a post-employment benefit plan, their initial measurement and subsequent recognition and measurement are consistent with the requirements of FRS 19 for the underlying post-employment benefit plan.

~~140~~**145** ~~In the case of an offer made to encourage voluntary redundancy, the~~ Measurement of a liability for unvested involuntary termination benefits shall be based on the number of employees expected to accept the offer reflect the likelihood of employees leaving voluntarily before the termination benefits vest.

Example illustrating paragraphs 138-145

Background

As a result of a recent acquisition, an entity plans to close a factory in 12 months and, at that time, terminate the employment of all of the remaining employees at the facility. Because the entity needs the expertise of the employees at the facility to complete some contracts, it announces a termination benefit plan as follows. Each employee who stays and renders service for the full 12-month period will receive as a termination benefit on the termination date a cash payment of three times the amount specified by employment legislation.

The entity's usual practice is to pay only the minimum termination benefits specified by employment legislation. For the employees at the factory, this minimum amounts to 10,000 per employee. Employment legislation also requires the entity to give 60 days' notice of its intention to terminate employment.

There are 120 employees at the factory, 20 of whom are expected to leave voluntarily before closure. Therefore, the total expected cash flows under the termination benefit plan are 3,200,000 (i.e. $20 \times 10,000 + 100 \times 30,000$).

As required by paragraph 141, the entity accounts for the benefits provided in accordance with the ongoing benefit plan (i.e. employment legislation) and the enhancement separately.

Ongoing benefit plan

A liability of 1,200,000 (i.e. $120 \times 10,000$) for the termination benefits provided in accordance with the ongoing benefit plan is recognised when the plan of termination is announced. The liability represents the benefits of 1,200,000 that the entity is required to pay in accordance with legislation.

continued...

Incremental benefits

The expected cash flows for the termination benefits that are incremental to what the employees would otherwise be entitled to receive (and relate to future services) are 2 million (i.e. $100 \times 20,000$). In this example, discounting is not required, so a liability and expense of 166,667 (i.e. $2,000,000 \div 12$) is recognised in each month during the future service period of 12 months. If the number of employees expected to leave voluntarily before closure changes, the entity makes corresponding adjustments to its estimate of the expected cash flows for termination benefits and hence the liability recognised.

Disclosure

Paragraph 141 is deleted and paragraphs 142 and 143 are amended and renumbered as 146 and 147 as follows.

~~142~~¹⁴⁶ As required by FRS 1, an entity discloses the nature and amount of an expense if it is material. ~~The expense for termination benefits may result in an expense needing to be disclosed disclosed in order to comply with this that~~ requirement.

~~143~~¹⁴⁷ ~~Where~~ When required by FRS 24, ~~Related Party Disclosures~~ an entity discloses information about termination benefits for key management personnel.

EFFECTIVE DATE

Paragraph 159D is added as follows.

159D An entity shall apply the amendments in [draft] paragraphs 7 and 132-147 from the beginning of its first annual period commencing on or after [1 January 2007]. Comparative information shall not be restated. Earlier application is encouraged. However, an entity shall apply the amendments only from the beginning of an annual period commencing on or after [date the amendments are issued]. If an entity applies the amendments before the effective date, it shall disclose that fact.

OTHER AMENDMENTS TO THE STANDARD

As a consequence of the amendments above, other paragraphs are amended as described below.

Paragraph 111 is amended as follows.

111 A curtailment occurs when an entity either:

- (a) ~~is demonstrably committed to~~ makes a material reduction in the number of employees covered by a plan; or
- (b) amends the terms of a defined benefit plan ~~such so~~ that a material element of future service by current employees will no longer qualify for benefits, or will qualify only for reduced benefits.

A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. ~~An event is material enough to qualify as a curtailment if the recognition of a curtailment gain or loss would have a material effect on the financial statements.~~ Curtailments are often linked with a restructuring the provision of termination benefits. Therefore, an entity accounts for a curtailment at the same time as for a any related restructuring termination benefits.