Organismo Italiano di Contabilità – OIC
(The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830

Mr. Henry Rees
Project Manager
IASB
30 Cannon Street
London EC4M 6XH
United Kingdom
commentletters@iasb.org

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Re: OIC comments on the "ED of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*".

Dear Mr Rees,

We are pleased to provide our comment on the "ED of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*".

Question 1

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

Answer

a) We agree with the introduction of an appropriate default standard for non-financial liabilities.
b) We agree with the Board's decision not to use 'provision' as a defined term.

Question 2

The Exposure Draft proposes to eliminate the term 'contingent liability'. The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations (see paragraph BC11). Hence, it highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30). The Basis for Conclusions also explains that many items previously described as contingent liabilities satisfy the definition of a liability in the Framework. This is because the contingency does not relate to whether an unconditional obligation exists. Rather it relates to one or more uncertain future events that affect the amount that will be required to settle the unconditional obligation (see paragraph BC23).

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

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

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

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

<u>Answer</u>

(a) We agree with eliminating the term "contingent liability"

(b)We disagree with the approach proposed because a certain practical implications. The concept of unconditional liability as an obligation to meet an obligation should a future event occur and to take into account the probability of that future event in determining the liability could give rise to unrealistic situations. For example, in a lawsuit, it is clear that the business has to meet the obligation in the event of the case going against it (stand ready to settle the liability), but if the business estimates the probability of a negative outcome at 20%, accounting for 20% of the liability would be unrealistic. The liability will either zero or 100%. The same logic holds for product guarantees, with the important difference that, on the basis of past experience, it is possible to measure (estimate) the magnitude of the liability but <u>not</u> the possibility of its occurrence. In other words, if the business estimates on the basis of past experience that it will have to replace 10% of the items sold because they are defective, the business has a reasonable idea of the loss it will incur. This is not a question of the probability of an event because the business knows (to a reasonable extent) that there is a 100% probability that 10% of the products will be returned.

In conclusion, we would prefer the Board to retain the previous approach.

<u>Question 3</u>

The Exposure Draft proposes to eliminate the term 'contingent asset'.

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

The Basis for Conclusions also explains that many items previously described as contingent assets satisfy the definition of an asset in the Framework. This is because the contingency does not relate

to whether an unconditional right exists. Rather, it relates to one or more uncertain future events that affect the amount of the future economic benefits embodied in the asset (see paragraph BC17).
The Exposure Draft proposes that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38 Intangible Assets rather than IAS 37 (except for rights to reimbursement, which remain within the scope of IAS 37). This is because such items are non-monetary assets without physical substance and, subject to meeting the identifiability criterion in IAS 38, are intangible assets (see paragraph A22 in the Appendix).
The Exposure Draft does not propose any amendments to the recognition requirements of IAS 38.
(a) Do you agree with eliminating the term ‘contingent asset’? If not, why not?
(b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?

Answer

(a) Consistent with our existing position on contingent liabilities, we believe that the Board ought to retain the existing concept of contingent asset.
(b) Since IAS 37 deals only with liabilities, contingent assets that satisfy the definition of an asset should be within the scope of IAS 38

Question 4

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?

Answer

a) We agree with the proposed amendment to the definition of a constructive obligation.
b) We support the additional guidance because it is appropriate and helpful.

Question 5

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognised unless they cannot be measured reliably. The Basis for Conclusions emphasises that the probability recognition criterion is used in the Framework to determine whether it is probable that settlement of an item that has previously been determined to be a liability will require an outflow of economic benefits from the entity. In other words, the Framework requires an entity to determine whether a liability exists before considering whether that liability should be recognised. The Basis notes that in many cases, although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require some outflow of resources. An example is an entity that has an obligation to decommission plant or to restore previously contaminated land. The Basis also outlines the Board’s conclusion that in cases

previously described as contingent liabilities in which the entity has an unconditional obligation and a conditional obligation, the probability recognition criterion should be applied to the unconditional obligation (ie the liability) rather than the conditional obligation. So, for example, in the case of a product warranty, the question is not whether it is probable that the entity will be required to repair or replace the product. Rather, the question is whether the entity's unconditional obligation to provide warranty coverage for the duration of the warranty (ie to stand ready to honour warranty claims) will probably result in an outflow of economic benefits (see paragraphs BC37-BC41). The Basis for Conclusions highlights that the Framework articulates the probability recognition criterion in terms of an outflow of economic benefits, not just direct cash flows. This includes the provision of services. An entity's unconditional obligation to stand ready to honour a conditional obligation if an uncertain future event occurs (or fails to occur) is a type of service obligation. Therefore, any liability that incorporates an unconditional obligation satisfies the probability recognition criterion. For example, the issuer of a product warranty has a certain (not just probable) outflow of economic benefits because it is providing a service for the duration of the contract, ie it is standing ready to honour warranty claims (see paragraphs BC42-BC47).
Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

<u>Answer</u>

We disagree for the same reasons we give in our answer to Question 2.

<u>Question 6</u>

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?

<u>Answer</u>

We disagree with the proposed amendments to the measurement requirement because the reasons for them are unclear. In our view, the proposals should be postponed until the conceptual questions have been studied thoroughly.

<u>Question 7</u>

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).
Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

Answer

We agree because it is coherent with the Framework.

Question 8

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?

Answer

(a) We are uncertain of the full implications of the amendments, particularly the phrase "… as a result of the entity's own action …". If it is highly probable that the entity has to take an action that makes the contract onerous, then a liability should be recognised even of the action is not yet taken.
(b) Yes, subject to our response under (a).
(c) The Board's objective is to issue high-quality standards. If it is certain that the standard issued meets this aim, then it is unclear why there must be an acceptance of convergence at all costs. For the OIC, this is a statement of a general nature and not limited to this specific instance.

Question 9

The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those costs (see paragraphs 61 and 62).
The Exposure Draft proposes guidance (or provides cross-references to other Standards) for applying this principle to two types of costs that are often associated with a restructuring: termination benefits and contract termination costs (see paragraphs 63 and 64).
(a) Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?
(b) Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?

Answer

We agree with the amendments proposed. In our opinion, these amendments clarify the standard and its practical application without changing its substance.

Yours sincerely

Prof. Angelo Provasoli
(OIC Chairman)