Provisions

Accounting Standards Advisory Forum meeting

April 2019

ASAF Agenda Paper 6

Meeting objective

- To hear your views on the scope of a possible project to make targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Background

The Board will soon discuss:

- whether to undertake a project to make targeted improvements to IAS 37, and
- if so, which aspects of IAS 37 to consider improving.

Scope of possible project

The staff plan to recommend that the Board undertakes a project focusing on:

1. aligning the IAS 37 liability definition and supporting guidance with the *Conceptual Framework*. Amendments could include replacing IFRIC 21 *Levies*.
2. clarifying which costs to include in the measure of a provision.
3. specifying whether the rate at which provisions are discounted should reflect the entity's own credit risk.

What won't be within the scope

The Board is not planning a fundamental review of IAS 37—stakeholders tell us that most aspects work well in practice.

The staff plan to recommend that the Board does not review the criteria for recognising liabilities, the overall measurement objective or the disclosure requirements. The reasons are explained in in Section C of this paper (pages 16–19).

Questions for ASAF members

Section

A

Question 1

The staff intend to recommend that the Board undertakes a project to make targeted improvements to IAS 37, focusing on the three aspects described in **Section A** of this paper.

Do you agree that these three aspects of IAS 37 should be considered for targeted improvements?

Possible focus of targeted improvements to IAS 37	Pages
Liability definition and supporting concepts	6–7
Measurement of provisions — costs to include	8–9
— discount rates	10

Questions for ASAF members

Section

B

Question 2

Section B describes four other aspects of IAS 37 that have been identified as possible problems with IAS 37 and could be added to the scope of the project.

The staff need to assess whether the existing requirements give rise to significant problems that could be resolved by amending IAS 37, and whether amendments could be developed within a reasonable timescale without absorbing disproportionate amounts of resource.

a) Do you think any of the four aspects of IAS 37 described in **Section B** satisfy these criteria?

b) If so, what problems are you aware of in practice and what amendments would you recommend to resolve them?

IFRS

Section A

Possible focus of project to make targeted improvements to IAS 37

A1 Liability definition and supporting concepts

IAS 37 requirements

In its definition of an obligating event, IAS 37 specifies that an event creates an obligation if it results in the entity having **no realistic alternative** to settling that obligation.

Paragraph 19 of IAS 37 states that it is only those obligations arising from past events **existing independently of an entity's future actions** (ie the future conduct of its business) that are recognised as provisions.

Problems identified

Problems can arise if an entity has an obligation that has arisen from its past actions but is also dependent its future actions. For example, an entity might have to pay a levy as a result of revenue it has earned in the current reporting period, but only if is still operating in a particular market on a particular future date. If leaving the market is not a realistic alternative, does the entity have a present obligation at the end of the current period?

The IFRS Interpretations Committee considered this question in developing IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* and IFRIC 21 *Levies*. In both cases, the Committee applied paragraph 19 and concluded that an entity does not have a present obligation if through its future actions it could avoid an outflow of resources (irrespective of whether those actions are realistic). However:

- the interpretations appear inconsistent with other requirements in IAS 37, especially requirements for restructuring costs;
- IFRIC 21 has been criticised by a range of stakeholders because it results in some periodic levies being recognised as expenses at a point in time even if their amount accumulates over a period; and
- IFRIC 21 is not consistent with some other IFRS Standards.

Continuing **Liability definition and supporting concepts**

Possible solutions

The questions described on page 6 do not arise only for provisions. Similar questions have arisen when the Board has considered other obligations that are conditional on an entity's future actions. So the Board decided to consider the questions as part of its Conceptual Framework project.

The revised *Conceptual Framework for Financial Reporting* issued in March 2018 (*Conceptual Framework*), provides concepts that could form the basis of clearer requirements in IAS 37. It defines a liability as a present obligation of an entity to transfer an economic resource as a result of past events. The supporting concepts explain that:

- an obligation is a duty or responsibility that an entity has no practical ability to avoid. If a duty or responsibility is conditional on a future action of the entity, the entity has an obligation if it has no practical ability to avoid taking that action; and
- a present obligation exists as a result of past events only if the entity has already taken an action and, as a consequence, will or may have to transfer an economic resource that it would not otherwise have had to transfer.

The Board could align the requirements in IAS 37 with those supporting concepts. This could include withdrawing IFRIC 21 and adding new requirements and illustrative examples for levies. The staff do not think that it would change the conclusions reached in IFRIC 6 or in any of the illustrative examples accompanying IAS 37.

At the same time, the Board could replace the liability definition in IAS 37 with the new definition in the *Conceptual Framework.*

A2 Measurement of provisions—costs to include

IAS 37 requirements

Paragraph 36 of IAS 37 requires entities to measure provisions at the best estimate of the expenditure required to settle the present obligation.

Problems identified

It is not clear which costs should be included as part of the 'expenditure required to settle' an obligation. Two questions often arise in practice:

1. If the obligation is to provide goods or services, should the entity include only the incremental costs of providing those goods or services (such as the cost of materials) or also an allocation of other directly related costs (such as depreciation of plant or equipment used to manufacture goods or provide services)?
2. Should an entity include costs payable to third parties, such as the legal costs associated with settling a lawsuit?

Practice varies, making financial statements less comparable.

Possible solutions

The Board could reduce diversity in practice by specifying which costs to include in determining the expenditure required to settle an obligation. It could be guided to answers to the questions above by its recent decisions on related topics—see page 9.

Continuing Measurement of provisions—costs to include

Incremental or all directly related costs

The Board has on its agenda a narrow-scope project to clarify IAS 37 requirements for onerous contracts.

The Board proposes to specify that, in assessing whether a contract is onerous, an entity should determine the cost of fulfilling the contract by including both the incremental costs of fulfilling that contract and an allocation of costs that relate directly to contract activities. (See Agenda Paper 4.)

The arguments supporting that proposal could support the same approach for measuring provisions.

Amounts payable to third parties

The measurement requirement in paragraph 36 of IAS 37 is similar to the 'fulfilment value' measurement basis now described in the *Conceptual Framework*.

Paragraph 6.17 of the *Conceptual Framework* states that the measure of fulfilment value includes 'not only the amounts to be transferred to the liability counterparty, but also the amounts that the entity expects to be obliged to transfer to other parties to enable it to fulfil the liability'.

A3 Measurement of provisions—discount rates

IAS 37 requirements

Paragraph 45 of IAS 37 requires entities to discount provisions for the time value of money.

Problems identified

IAS 37 does not specify whether the rates used to discount provisions should reflect the risk that the entity may fail to fulfil its liability (its own credit risk). Some entities exclude own credit risk, others include it. Differences in practice impair the comparability of financial statements of entities with large long-term provisions (for example, provisions for decommissioning long-life assets). An absence of requirements to disclose the discount rates used can further impede comparability.

In 2010, the IFRS Interpretations Committee was asked to clarify this aspect of IAS 37. It decided the matter would be best addressed as part of a wider project to review IAS 37.

Possible solutions

The Board could specify in IAS 37 whether the rate used to discount provisions should include or exclude own credit risk. The Board could ask stakeholders for views on which rate leads to a more useful measure of a provision.

The Board could also consider adding to IAS 37 requirements for disclosure of information about discount rates used.

Section B

Other aspects of IAS 37 that could be included in the scope of a project

B1 Measurement of provisions—risk adjustment

IAS 37 requirements

Paragraph 42 of IAS 37 requires risk to be taken into account in reaching the best estimate of a provision.

Paragraph 43 notes that that a risk adjustment may increase the amount at which a liability is measured.

Possible problem

IAS 37 does not specify the objective of the risk adjustment, describe the circumstances in which a risk adjustment is required or explain how the adjustment should be measured.

Some people think IAS 37 requires a risk adjustment only if a provision is measured at its most likely outcome—the objective being to reflect other possible outcomes. Others think that a risk adjustment is required even if a provision is measured at its expected value (probability weighted average of all possible outcomes)—the objective being to reflect the price of bearing the risk that the costs will be higher than those reflected in the expected value calculation.

Possible solutions

Other IFRS Standards that require risk adjustments (eg IFRS 17 *Insurance Contracts*) specify the objective of those adjustments, which helps clarify when an adjustment is required and how it should be measured. However, it could be difficult to specify an objective for the risk adjustment in IAS 37 without first clarifying the overall measurement objective. And the overall measurement objective is not being considered for review at present—see Section C, slide 18.

The Board could specify that provisions in the scope of IAS 37 should be measured without a risk adjustment. Some users of financial statements have suggested this solution in the past arguing that, in the absence of established techniques for measuring the risk associated with the IAS 37 provisions, measures that exclude risk adjustments would provide more transparent and useful information.

B2 Onerous contracts

IAS 37 requirements

Paragraph 66 of IAS 37 states that, if an entity has a contract that is onerous, it should recognise the present obligation under the contract as a provision.

Paragraph 10 of IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Possible problem

Questions arise in practice about how to assess whether a contract is onerous. Stakeholders have suggested that, in addition to clarifying which costs are included (see page 9), the Board could clarify:

a) whether the phrase ‘economic benefits expected to be received under a contract’ should be interpreted narrowly (to include only the economic benefits to which the entity becomes directly entitled under the contract) or more broadly (to include other expected indirect benefits, for example access to future profitable contracts).

b) how an entity should measure the cost of fulfilling a contract if the contract will be fulfilled using the entity’s existing assets and those assets are carried at an amount other than cost. An example would be a contract to be fulfilled using agricultural produce or biological assets, which are carried at fair value less costs to sell.

c) the circumstances in which contracts should be combined or segmented.

Possible solution

The Board could consider adding specific requirements to IAS 37. However, none of the questions listed above has been referred to the IFRS Interpretations Committee. These questions may best be addressed by practitioners on a case by case basis, applying existing IFRS requirements to the particular facts and circumstances of the case.

B3 Reimbursement rights—recognition threshold

IAS 37 requirements

Paragraph 53 of IAS 37 states that, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement is recognised when, and only when, it is **virtually certain that reimbursement will be received** if the entity settles the obligation.

Possible problem

A few stakeholders have asked the Board to review the recognition criterion for reimbursement rights. They have given examples of situations in which an entity's **right to reimbursement** for a recognised liability is virtually certain, receipt is highly probable and measurement uncertainty is low, but they think no reimbursement asset can be recognised because **receipt** is not virtually certain.

Possible solution

A possible solution could be to amend the recognition criterion to require it to be **virtually certain that the entity has a right to reimbursement**. Uncertainty about receipt could be taken into account in the measurement of the asset or the Board could add a second threshold relating to recovery—for example requiring it to be probable that reimbursement will be received.

In a previous project to amend IAS 37, the Board's proposals included a proposal to amend the recognition threshold for reimbursement rights in this way. Most respondents who commented on this proposal supported it. However, it was never finalised—the Board took the project off its agenda without finalising any of its proposals.

B4 Contingent assets—events after the reporting period

IAS 37 requirements

IAS 37 defines contingent assets as possible assets whose existence will be confirmed only by uncertain future events. An example is the possible asset of a plaintiff in a lawsuit—a possible right to receive compensation—which will be confirmed only by a future court ruling.

IAS 37 prohibits recognition of contingent assets. However, it states that when the realisation of income is virtually certain, the related asset is not a contingent asset and its recognition is appropriate. Paragraph 35 of IAS 37 states that an asset is recognised in the period in which it becomes virtually certain that an inflow of economic benefits will arise.

Possible problem

Paragraph 35 of IAS 37 applies when a favourable court ruling or settlement confirms that a plaintiff is virtually certain to receive compensation. That paragraph is often read to mean that the plaintiff recognises its right to compensation in the period in which the court ruling or settlement occurs—even if it relates to a right that existed at the end of the previous reporting period, and the financial statements for that previous reporting period have not yet been authorised for issue. In other words, a court ruling or settlement of a court case is treated by a *plaintiff* as an 'non-adjusting event'.

In contrast, applying paragraph 16 of IAS 37 and paragraph 9 of IAS 10 *Events after the Reporting Period,* a court ruling or settlement is treated by a *defendant* as an 'adjusting event'. Some stakeholders have suggested paragraph 35 of IAS 37 should be clarified to eliminate the apparent inconsistency between the requirements for plaintiffs and those for defendants.

Possible solution

If the Board concluded that there was an inconsistency, it could amend the wording of paragraph 35 of IAS 37 to specify that in assessing contingent assets, an entity takes account of evidence provided by events after the reporting period.

Section C

Aspects of IAS 37 that are not being considered for review

C1 Recognition criteria

IAS 37 requirements

Paragraph 14 of IAS 37 requires a provision to be recognised in financial statements if:

1. an entity has a present obligation as a result of a past event;
2. it is probable that an outflow of resources will be required to settle the obligation; and
3. a reliable estimate can be made of the amount of the obligation.

Reasons for not reviewing the recognition criteria

In a previous (never completed) project to amend IAS 37, the Board proposed to remove from IAS 37 the second of the three recognition criteria—the 'probable outflows' criterion.

However, many stakeholders opposed this proposal. Few of the users of financial statements consulted said they would find recognition of low-probability liabilities useful. And preparers of financial statements argued that the costs of recognising and measuring low-probability liabilities would be substantial, and outweigh any benefits. The Board took the project off its agenda without finalising its proposals.

C2 Measurement objective—best estimate

IAS 37 requirements

Paragraph 36 of IAS 37 requires entities to measure provisions at the best estimate of the expenditure required to settle the present obligation.

Paragraph 37 states that this amount is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

Paragraph 40 states that for a single obligation, the individual most likely outcome may be the best estimate of the liability, but an entity considers other possible outcomes.

Reasons for not reviewing the measurement objective

The measurement objective in IAS 37 is not precise and people interpret it in different ways. In a previous (never completed) project to amend IAS 37, the Board proposed to specify that:

1. the objective is to measure the amount the entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party; and
2. to satisfy that objective, an entity would measure a liability at the expected value (probability-weighted average) of the possible outcomes.

However, many respondents disagreed with this proposal arguing, among other things, that the expected value is not always the most useful measure of a provision—especially if the expected value is not one of the possible outcomes (as might be the case, for example, for litigation provisions).

The Board sought further input from its Global Preparers Forum and Capital Markets Advisory Committee when those two groups met jointly in June 2015. Members of both groups expressed a view that IAS 37 should continue to allow management to use judgement to arrive at the best estimate of the liability.

The Board took the project off its agenda without finalising its proposals.

C3 Disclosure requirements

IAS 37 requirements

Paragraph 85 requires entities to disclose for each class of provision:

1. a description of the nature of the obligation and expected timing of any outflows; and
2. an indication of the uncertainties about the amount and timing of the outflows.

Paragraph 86 requires entities to disclose for each class of contingent liability (unless remote):

1. an estimate of its financial effect; and
2. an indication of the uncertainties about the amount or timing of any outflow.

Paragraph 92 permits entities not to disclose information in 'extremely rare' cases where disclosure would prejudice seriously the entity's position in a dispute.

Reasons for not reviewing the disclosure requirements

From time to time, some investors have told us that the information disclosed about provisions and contingent liabilities can be poor.

However, responses to the Board's last agenda consultation did not identify a need for either a fundamental review of the IAS 37 disclosure requirements or targeted improvements to address specific shortcomings in those requirements.

IAS 37 applies to many and diverse types of obligations—including decommissioning obligations, litigation liabilities, taxes other than income taxes and onerous contracts. So the disclosure requirements have to be general in nature, and the quality of information disclosed can depend on how well preparers of financial statements apply the general requirements to particular types of obligation. Inadequate disclosure could reflect a need for better application of existing requirements, rather than a need to enhance existing requirements.