

International Financial Reporting Standards

Research—Provisions, Contingent Liabilities and Contingent Assets (IAS 37)

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or the IFRS Foundation.

Purpose of ASAF discussion

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Purpose of ASAF discussion

- To update you on status of IASB staff research on provisions, contingent liabilities and contingent assets (IAS 37).
- To gather your initial thoughts on:
 - which of a range of possible problems the IASB should address; and
 - what further research/analysis is needed.

Topics for discussion

1. Project overview (slides 5–7 and background paper 4A)
2. Possible problems with IAS 37 (slides 11–19 and background paper 4B)
3. Implications of *Conceptual Framework* proposals (slides 20-23 and background paper 4C)

The background papers are papers prepared for discussion at an IASB education session (originally scheduled for the June IASB meeting, now deferred to the July IASB meeting).

Project overview

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Research project on IAS 37

- The objective of this project is to:
 - decide whether to take on an active project to amend IAS 37; and
 - if so, what the scope of the active project should be.
- The IASB would elicit stakeholder views, probably by publishing a Discussion Paper, before starting an active project.
- Reasons for considering possible amendments to IAS 37:
 - difficulties in interpreting the guidance on identifying liabilities;
 - recognition thresholds that are higher than those for liabilities in other Standards
 - lack of clarity on measurement requirements and evidence of diversity in practice
 - lack of guidance on identifying and measuring onerous contract liabilities.

- Our initial research involves:
 - gathering information about problems in applying IAS 37 in practice
 - evaluating implications of the proposals in the Conceptual Framework Exposure Draft.
- This project is not a continuation of the earlier project. There is no presumption that the preliminary views will be same as the proposals of the earlier project.
- The IASB is likely to wait until it is close to finalising the *Conceptual Framework* before reaching preliminary views on IAS 37.

Questions for discussion

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Questions for discussion

1. Which aspects of IAS 37, if any, do you recommend that we include in a project to amend IAS 37?
2. Which aspects do you think need further research and analysis?
3. Would you be interested in researching and analysing any of these aspects for future ASAF discussion?

Appendix

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Possible problems with IAS 37

(Background paper 4B)

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- The guidance in IAS 37 on identifying liabilities seems contradictory:
 - paragraph 19 - only obligations ‘existing independently of an entity’s future actions’; but
 - paragraph 10 - obligating event is an event that ‘results in the entity having no **realistic** alternative to settling the obligation’.
- Consequences highlighted by:
 - IFRIC 21 *Levies*;
 - requirements inconsistent with other requirements in IAS 37 (eg restructuring costs) and with other Standards (eg share-based payments)
 - concern that requirements do not result in a faithful representation.

Recognition criteria—provisions

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- IAS 37 has three recognition criteria for provisions.
- One of the criteria, '*probable outflows*', has been a subject of much debate in the past.
- Such a threshold is generally not applied in other Standards.
- But a previous proposal to remove this criterion from IAS 37 was opposed by many respondents.
- Concepts proposed in the *Conceptual Framework* Exposure Draft could help guide the IASB (see slide 22).

Lack of clarity in measurement guidance in IAS 37 and diversity in practice regarding:

- estimating future cash flows for single obligations:
 - especially in circumstances where most likely outcome is not close to expected value or median outcome.
- risk adjustments and discounting:
 - IAS 37 does not clarify the circumstances in which a risk adjustment is required.
 - IAS 37 does not explain how a risk adjustment should be measured
 - IAS 37 does not specifically address “*non-performance risk*”
- costs included in a provision:
 - for obligations to provide goods or services
 - direct costs only, or include allocation of overheads?

- IAS 37 applies to a wide range of onerous contracts
- IAS 37 contains limited guidance on identifying and measuring onerous contracts.
- Stakeholders have suggested a need for more guidance on:
 - when a contract becomes onerous
 - interpretation of ‘*economic benefits expected to be received*’ – narrow contractual benefits or wider indirect benefits
 - whether ‘cost of fulfilling’ a contract includes only direct incremental costs or also an allocation of indirect costs
 - whether an entity should ever divide a contract into components.

- Contingent assets:
 - threshold for recognising contingent assets is higher than threshold for recognising contingent liabilities
 - users support asymmetry
 - but some people have questioned why court settlements after the reporting period are ‘adjusting’ events for contingent liabilities but not for contingent assets.
- IASB could seek views on aligning the treatment of court settlements

Reimbursement rights

- Reimbursements are recognised if it is virtually certain that they will be received.
- Some preparers have suggested that the recognition criterion is too restrictive.
- We do not know how widespread concerns are.

Scope

- IAS 37 applies only to liabilities of uncertain timing or amount.
- Previous project proposed to widen the scope to make it a 'catch all' Standard for non-financial liabilities.
- The response to such proposals were mixed.
- Evidence of practical implications of widening the scope of IAS 37 would be helpful.

Terminology

- The terms ‘provision’, ‘contingent liability’ and ‘contingent asset’ are open to misinterpretation.
- But changing terminology could be disruptive.
- Further consultation could help IASB reach a view on whether benefits of changing terminology would exceed the costs.

Implications of *Conceptual Framework* proposals

(Background paper 4C)

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Identifying liabilities

Specific area	IAS 37	<i>Conceptual Framework</i>
Levies	<ul style="list-style-type: none">IFRIC 21 identifies liabilities only when obligations become unconditionalThe result can be that a liability and an expense are recognised at a point in timeStakeholders think IFRIC 21 does not faithfully represent periodic levies	<ul style="list-style-type: none">Concepts identifying a liability if:<ul style="list-style-type: none">a) entity has no practical ability to avoid transfer; andb) entity has received benefits or conducted activities that establish extent of obligation.Applying the proposed concepts, liabilities for accumulating periodic levies would be recognised incrementally over the period to which the levy refers
Restructuring costs	<ul style="list-style-type: none">IAS 37 identifies liabilities when an entity has announced a restructuring planThere are different views on whether an announcement creates an obligation	<ul style="list-style-type: none">The proposed concepts could reconcile the different viewsThe practical implications might not be great.

Recognition criteria

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IAS 37

- The IASB previously proposed to remove the 'probable outflows' criterion, which is not in other Standards
- Many stakeholders argued that the probable outflows criterion serves a useful purpose

Conceptual Framework

- The Conceptual Framework Exposure Draft proposes that recognition requirements may need to vary between Standards.
- In some cases, recognition would not provide information that is sufficiently useful to justify the costs.
- Liabilities within scope of IAS 37 have characteristics that could provide a basis for retaining the 'probable outflows' criterion.

IAS 37

- Existing IAS 37 measurement requirements are unclear
- The IASB previously proposed more precise requirements, including:
 - measurement of a liability at the amount the entity would rationally pay to be relieved of it;
 - by estimating ‘expected value’ of future outflows; and
 - including a risk adjustment plus contractor margin
- Stakeholders opposed key aspects of those previous proposals.

Conceptual Framework

- The proposed concepts could lead the IASB to conclusions that differ from the previous proposals.
- The IASB might focus on ‘fulfilment value’ when developing measurement requirements for IAS 37.
- The IASB might consider whether and how to customise ‘Fulfilment Value’ to provide most useful information and take account of cost constraint. For example:
 - not requiring ‘expected value’ estimates in all circumstances;
 - excluding effects of non-performance risk;
 - requiring outflows to be measured at cost (excluding margin).