

STAFF PAPER

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Project	Research—provisions, contingent liabilities and contingent assets (IAS 37)
Paper topic	Project overview
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Purpose of this paper

- 1 This paper gives background information about the research project on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- 2 It starts with a brief outline of IAS 37:
 - (a) the requirements of IAS 37 (paragraphs 4-5); and
 - (b) the range of transactions within its scope (paragraphs 6-7);
- 3 The paper then gives an overview of the research project:
 - (a) the objective (paragraph 8);
 - (b) the reasons for considering possible amendments to IAS 37 (paragraph 9-11);
 - (c) the likely output (paragraph 12-13);
 - (d) the relationship between this research project and the IASB's previous project to amend IAS 37 (paragraph 14-17);
 - (e) a need to wait for the revised *Conceptual Framework* (paragraph 18); and
 - (f) further work scheduled in the meantime (paragraph 19).

About IAS 37

IAS 37 specifies how entities should report uncertain liabilities

- 4 IAS 37 defines a provision as a liability of uncertain timing or amount. Some provisions (such as contractual warranty obligations) are subject only to ‘outcome uncertainty’—it is certain that the entity has a liability but uncertain what outflows, if any, will be required to settle the liability. Others (such as a possible liability to pay damages for an alleged act of wrong-doing) are also subject to ‘existence uncertainty’—the existence of the liability is disputed and will be confirmed only on the occurrence of a future event, such as a court ruling.
- 5 IAS 37 addresses the way in which an entity should report uncertain liabilities:
- (a) IAS 37 provides guidance to help interpret the **definition** of a liability in difficult situations, for example if an obligation is not legally enforceable or is conditional on the entity’s future actions.
 - (b) IAS 37 specifies **recognition criteria**, ie the circumstances in which an entity must include a provision in its statement of financial position. Three criteria must all be met:
 - i) it is more likely than not that a liability exists; and
 - ii) it is probable (= more likely than not) that an outflow of resources will be required to settle the liability; and
 - iii) a reliable estimate can be made of the amount of the liability.
 - (c) IAS 37 uses the term **contingent liability** to describe any liability or possible liability within its scope that fails to satisfy at least one of the three recognition criteria. IAS 37 prohibits recognition of contingent liabilities.
 - (d) IAS 37 specifies how to **measure** provisions by estimating the future cash flows and discounting those cash flows to their present value.
 - (e) IAS 37 requires entities to **disclose** the uncertainties surrounding recognised provisions and unrecognised contingent liabilities. Disclosure of contingent liabilities is required unless the possibility of any outflow is remote.

The scope of IAS 37 is broad

- 6 IAS 37 applies to all liabilities of uncertain timing or amount that are not within the scope of another Standard. Such liabilities include:
- (a) obligations to pay compensation or fines for breaching civil or criminal laws or industry regulations.
 - (b) obligations to decommission plant or equipment at the end of its useful life or to dispose of waste products.
 - (c) obligations to rectify environmental damage.
 - (d) obligations for some costs of restructuring a business.
 - (e) obligations to pay some taxes and levies. (Only taxes based on an entity's profits are within the scope of IAS 12 *Income Taxes*.)
 - (f) warranties of goods sold to customers.
 - (g) statutory financial guarantees. These financial guarantees are not within the scope of IFRS 9 *Financial Instruments* because they are not contractual.
 - (h) many onerous contracts. Even if a contract is within the scope of another Standard (such as a sales contract within the scope of IFRS 15 *Revenue from Contracts with Customers*), IAS 37 may apply for the purpose of measuring the additional amount that is recognised as a liability if the contract becomes onerous.
- 7 IAS 37 also applies to some assets that are closely related to the liabilities within its scope. It applies to:
- (a) contingent assets: defined in IAS 37 as possible assets whose existence is uncertain but will be confirmed by future events. An example is the possible right of a plaintiff in a lawsuit to receive compensation for alleged wrongdoing.
 - (b) rights to reimbursement for any liabilities within the scope of IAS 37. An example is a car manufacturer's right to reimbursement from its component suppliers for some of the costs of fulfilling its warranty obligations to customers.

About this research project

The objective is to decide whether to take on an active project to amend IAS 37

- 8 In this research project, we are gathering evidence to help the IASB decide:
- (a) whether to take on an active project to amend aspects of IAS 37; and
 - (b) if so, what the scope of the active project should be—which topics the IASB should address out of a range of matters raised with it in recent years.

There are several reasons for considering possible amendments to IAS 37

- 9 When IAS 37 was issued in 1998, it filled a significant void. For example, before its issue, entities could make provisions for future costs that were not present obligations, and this freedom provided significant scope for earnings manipulation. IAS 37 restricts provisions to items meeting the definition of a liability. The Standard is widely credited with having substantially improved financial reporting as a result.
- 10 However, IAS 37 has imperfections and people have expressed concerns about some aspects of the Standard. For example:
- (a) the IASB and the IFRS Interpretations Committee have encountered difficulties interpreting IAS 37 guidance on identifying liabilities. Stakeholders have expressed dissatisfaction with one interpretation, IFRIC 21 *Levies*, in particular.
 - (b) questions have been raised about recognition thresholds in IAS 37. These thresholds require entities to exclude some liabilities and some reimbursement rights from their financial statements. The thresholds are higher than those that the IASB has since applied in other Standards.
 - (c) aspects of the existing measurement requirements are unclear and there is evidence of diversity in practice. The IFRS Interpretations Committee has received requests for further guidance on discount rates and measurement of onerous contract liabilities, and passed on those requests to the IASB.
- 11 Agenda paper 14B explains more fully the range of problems that have been raised with the IASB in recent years.

The IASB would elicit stakeholder views before adding a project to its active agenda

- 12 The IASB's *Due Process Handbook* notes that the IASB would normally put together a proposal to make major amendments to a standard only after it has published a Discussion Paper and considered the comments received from that consultation.¹
- 13 The IASB has not yet decided what the output of this research project should be. But if it reaches preliminary views in favour of major amendments to IAS 37, the most helpful output might be a Discussion Paper that:
- (a) sets out the various problems that it has considered; and
 - (b) gives its preliminary views on whether and how IAS 37 should be amended to address each problem.

There is no presumption that the IASB's preliminary views will be the same as those it reached in its previous project

- 14 The IASB started a previous project to amend IAS 37 in 2002. The project arose from two other projects:
- (a) a project to revise IFRS 3 *Business Combinations*, during which the IASB tentatively decided to align the recognition criteria in IAS 37 with those in IFRS 3.
 - (b) a joint project of the IASB and Financial Accounting Standards Board (FASB) to eliminate unnecessary differences between IFRSs and US generally accepted accounting principles (US GAAP). As part of that project, IASB proposed to align the requirements for restructuring costs in IAS 37 with the requirements in US GAAP.

¹ IASB and IFRS Interpretations Committee Due Process Handbook, February 2013, paragraph 5.5.

- 15 Although the original purpose of the project to amend IAS 37 was to implement decisions reached in other projects, the IASB took the opportunity to also propose other changes to IAS 37, in particular to provide more guidance to support the measurement requirements. In 2005, the IASB published an Exposure Draft setting out all of the proposed amendments to IAS 37. It then exposed revised proposals for measurement in 2010.
- 16 Respondents expressed significant opposition to some of the proposals in both the 2005 and 2010 Exposure Drafts. In 2010, the IASB suspended the project to amend IAS 37, to allow it to focus on higher priority projects, and pending completion of its project to revise its *Conceptual Framework*.
- 17 The current research project is not a continuation of the previous project. We are looking at all of the issues afresh. Although we will make use of evidence gathered in the previous project, we are not presuming that the preliminary views that the IASB reaches in this project will be the same as the proposals it put forward in its previous project. Indeed, the IASB could be steered towards quite different conclusions by:
- (a) proposed changes to the *Conceptual Framework*; and
 - (b) arguments put forward by respondents to the previous Exposure Drafts.

The IASB is likely use the revised Conceptual Framework to help it reach preliminary views on IAS 37

- 18 As explained in Agenda Paper 14C, concepts proposed in the *Conceptual Framework* Exposure Draft could have significant implications for any review of IAS 37. In particular, proposed concepts on identifying liabilities could guide the IASB in developing new requirements for transactions such as levies. So the IASB is likely to wait until it is close to finalising revisions to the *Conceptual Framework* before publishing any preliminary views on possible amendments to IAS 37. It is aiming to finalise revisions to the *Conceptual Framework* in 2016.

In the meantime, we are gathering more evidence about practical problems and possible solutions

- 19 In the meantime, we are gathering more evidence about the nature and extent of practical problems with IAS 37, and views on possible solutions to the problems identified. The papers for this meeting present the evidence that the staff have gathered to date. Over the next few months we plan to consult various stakeholders with a view to developing the analysis further. We have scheduled discussions with the IASB's Capital Markets Advisory Committee and Global Preparers Forum in June, Accounting Standards Advisory Forum in July and World Standard Setters in September.