STAFF PAPER

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Project	**Provisions and contingent liabilities (IAS 37)**
Paper topic	Session overview and background information

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Session overview

1 The IASB is conducting research on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The purpose of the research is 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.

2 At this meeting, we are seeking CMAC and GPF input on two particular matters:

(a) *the criteria for recognising liabilities*—would lowering the thresholds (so that more liabilities are recognised) provide investors with useful information at a cost that does not exceed the benefits?

(b) *measuring a single liability*—which estimate of future cash flows provides the most useful information at a cost that does not exceed the benefits: the most likely outcome, the probability-weighted average of the possible outcomes, or some other amount within the range?

3 The rest of this paper provides you with background information. Agenda Paper 3B contains case studies and questions for discussion during break-out sessions.

Information about the Capital Markets Advisory Committee (CMAC) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/CMAC/Pages/CMAC.aspx

Information about the Global Preparers Forum (GPF) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/Pages/Global-preparers-forum.aspx

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 damages 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 the IASB's research project

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

8 The purpose of this research is to gather 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 aspects of IAS 37 that the project could address

9 The IASB is considering the need for an active project now because several possible problems have been identified with IAS 37, and proposed changes to the IASB *Conceptual Framework*, if finalised, could help the IASB resolve some of those problems.

10 Matters that have been raised as possible problems include:

(a) *the requirements for identifying liabilities*—and in particular the way in which those requirements have been interpreted in IFRIC 21 *Levies*. Many levies are charged on entities operating in a particular market on a specified date each year. In combination with Standards addressing the identification and recognition of assets, IFRIC 21 can result in such levies being recognised as an expense in full on the specified date, ie at a single point in time. Some stakeholders, including both preparers and users of financial statements, have expressed concern about this outcome. They think it does not always provide a faithful representation of the entity's financial position and performance, especially if the amount of the levy is proportional to some measure of the entity's activities (eg its revenues or the length of its accounting period) and accumulates over time. Many people believe that the economic substance of such levies would be more faithfully represented by recognising the expense gradually as the amount of the levy accumulates.

(b) *the recognition criteria for liabilities.* Some have questioned the 'probable outflows' criterion described in paragraph 5(b)(ii) above. Other IFRSs set no such criterion. Moreover, some people think the criterion can delay the reporting of useful information.

(c) *the recognition criteria for reimbursement rights.* Applying IAS 37, entities recognise reimbursement rights as assets only once it is virtually certain that reimbursement will be *received*. The threshold prevents recognition of some assets whose existence is not in doubt and for which future cash inflows are both probable and subject to relatively little measurement uncertainty. Such assets would be recognised if they were within the scope of other Standards, such as IFRS 4 *Insurance Contracts*. Some preparers have expressed a view that the IAS 37 threshold is too high and prevents some entities with reimbursement assets from providing a faithful representation of their financial position.

(d) *the measurement requirements.* Aspects of the IAS 37 measurement requirements are unclear and there is diversity in their practical application. For example:

  (i) there is diversity in the way entities measure single liabilities that have a range of possible outcomes. IAS 37 is unclear whether a single liability should be measured at its most likely outcome, at the probability-weighted average (expected value) of the possible outcomes or at some other amount within the range.

  (ii) IAS 37 mentions risk adjustments but gives little guidance on when or how the measure of a provision should be adjusted for risk. Auditors have pointed out that the lack of guidance leaves scope for variation in the estimation of provisions.

  (iii) a submission to the IFRS Interpretations Committee has highlighted diversity in the rates used to discount future cash flows, particularly in whether entities take into account their own credit risk. Many entities use a risk-free rate, but some use their own borrowing rate. Use of the entity's borrowing rate can result in substantially lower measures of long-term liabilities.

  (iv) another submission to the IFRS Interpretations Committee has suggested a need for more guidance on identifying onerous contracts and on measuring onerous contract liabilities.

The IASB is likely to be guided by its revised Conceptual Framework

11 New concepts proposed in the *Conceptual Framework* Exposure Draft would 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* (which it is aiming to do in 2016) before publishing any preliminary views on possible amendments to IAS 37.

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

12 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 problems identified. At this meeting, we will be seeking your views on two particular matters:

(a) the recognition criteria—see paragraphs 14-23 below; and

(b) measurement of single liabilities—see paragraphs 24-33 below.

Recognition criteria

IAS 37 requires liabilities to be recognised if three criteria are met

13 In accounting terminology, 'recognition' of an asset or a liability means the inclusion of the asset or liability at a single monetary amount in relevant totals in the statement of financial position.

14 IAS 37 specifies that liabilities within its scope should be recognised if three recognition criteria are all met:

(a) if on the basis of all available evidence, it is more likely than not that a liability exists; and

(b) if it is probable (= more likely than not) that an outflow of resources will be required to settle the liability; and

(c) if a reliable estimate can be made of the amount of the liability.

Other Standards do not have a 'probable outflows' recognition criterion

15 Other Standards do not have a 'probable outflows' recognition criterion. In particular, there is no such recognition criterion for financial liabilities or for contingent liabilities assumed in a business combination. The inconsistency has caused some people to question the inclusion of the criterion in IAS 37. Those people take the view that:

(a) an asset or a liability should be recognised if it satisfies the definitions in the *Conceptual Framework*. Otherwise financial statements are incomplete;

(b) if there is a low probability of a future outflow, this factor should be reflected by measuring the liability at an amount that reflects the low probability, not by entirely omitting the liability from the statement of financial position; and

(c) recognition can provide useful information, even if outflows are not probable. For example, an increase in the amount recognised from one period to the next can give an early indication of a change in management's assessment of the probability or possible amount of future outflows.

Proposed new concepts could justify differences between IAS 37 and other IFRSs

16 The *Conceptual Framework* Exposure Draft proposes concepts for recognition. These concepts, if and when finalised, could guide the IASB in any future review of the recognition criteria in IAS 37.

17 The *Conceptual Framework* Exposure Draft indicates that consistency with other Standards would not in itself be a reason for removing the probable outflows criterion from IAS 37. It proposes that recognition requirements may need to vary between Standards, and that recognition of some assets or liabilities provides information that is not sufficiently useful to justify the cost of providing it. In some cases, the cost of recognition may outweigh the benefits.

18 Liabilities within the scope of IAS 37 have one particular characteristic that distinguishes them from many other liabilities. They typically cannot be measured by reference to an observable transaction price. They tend not to be traded, so do not have an observable *current* market price. Furthermore, and perhaps more unusually, they tend not to have even *arisen* in an exchange transaction that provides an observable *historical* transaction price for the liability.

19 Observable transaction prices can often be obtained at a relatively low cost, take into account the probability of various outcomes and are usually subject to relatively little measurement uncertainty. Consequently, even if the only observable transaction price for a liability is a historical one, there is likely to be at least one measure of the liability for which the benefits of recognition exceed the costs. It could be argued that the need for recognition criteria in IAS 37 stems from the absence of *any* observable transaction price.

20 The *Conceptual Framework* Exposure Draft proposes that recognition of an asset or a liability might not provide information that is sufficiently relevant to justify the costs of providing it:

(a) in some of the circumstances in which it is uncertain whether an asset or liability exists;

(b) in some of the circumstances in which there is only a low probability of an inflow or an outflow of economic benefits; or

(c) if the level of measurement uncertainty is so high that the resulting information has little relevance.

We would like your views on whether there are any problems in practice

21 The *Conceptual Framework* Exposure Draft discusses the same factors as those underpinning the existing recognition criteria in IAS 37—existence uncertainty, a low probability of outflows and exceptionally high measurement uncertainty. However, the *Conceptual Framework* Exposure Draft does not necessarily suggest thresholds as *high* as those in IAS 37. For example:

(a) the *Conceptual Framework* Exposure Draft envisages that recognition of a particular liability may not provide useful information in some of the circumstances in which there is only a 'low' probability of outflows. Low is not defined. But some people might argue that the 50% threshold in IAS 37 filters out more liabilities than just those with 'low' probabilities—a probability of 45%, say, is not particularly low.

(b) the *Conceptual Framework* Exposure Draft proposes that it will often be a combination of factors (existence uncertainty, a low probability of outflows and exceptionally high measurement uncertainty), rather than any single factor, that causes the information provided by recognition to lack relevance. IAS 37 requires only one of these factors to be present (if the liability fails any one of the three recognition criteria, it is not recognised).

22 Accordingly, in reaching a preliminary view on the IAS 37 recognition criteria, the IASB might wish to consider whether the existing thresholds are too high. However, new financial reporting requirements developed by the IASB should be designed to address problems identified with the existing requirements. Combining this objective with the recognition concepts proposed in the *Conceptual Framework* Exposure Draft suggests that the IASB would consider changing the existing thresholds only if it has evidence that:

(a) there are examples in practice of liabilities that do not satisfy existing IAS 37 recognition criteria but whose recognition would provide useful information to investors, lenders or other creditors; and

(b) the costs of recognising these liabilities would not exceed the benefits.

23 We will be considering this topic in the break-out sessions, using Case Study 1 in Agenda Paper 3B.

Measurement—estimating future cash flows

Existing IAS 37 requirements for single liabilities are unclear

24 IAS 37 requires entities to measure liabilities at 'the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'. It adds that this 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'.

25 This amount is usually estimated by forecasting the future cash flows and discounting them to their present value.

26 IAS 37 discusses how entities should measure a liability with a range of possible future cash flows. For large populations, it is clear. It states that:

> Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'.

27 However, for single liabilities, it is less clear. It states that:

> Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. For example, if an entity has to rectify a serious fault in a major plant for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

28 This paragraph seems to say that the most likely outcome is an appropriate measure only in circumstances in which that outcome is reasonably close to the expected value of the possible outcomes, or to the median outcome of the range. However, the guidance does not specify how the cash flows should be measured in any other circumstances.

There is evidence of diversity in practice

29 Some people think that the measurement objective in IAS 37 implies expected value measurements even for single obligations: an estimate of the amount that an entity would rationally pay to settle a single liability or transfer it to another party at the end of the reporting period would take into account all possible outcomes and their probabilities. However, views diverge. The IFRS manuals published by the four largest accounting firms variously advise that:

(a) the expected value method *can* be applied to a single liability with various possible outcomes.

(b) expected value is *not* a valid technique for a single liability. The most likely outcome is an appropriate measure if it is close to expected value. Otherwise, the outcome nearest to expected value is often appropriate.

(c) usually the most likely outcome is the best estimate of a single liability. (An example suggests that for a liability with two possible outcomes, the more likely of the two outcomes is the best estimate.)

(d) whilst IAS 37 provides an example of a case in which the best estimate of a single liability might have to be larger than the individual most likely outcome, it gives no indication of how this increment should be determined.

30 The diversity in these views is evidence of diversity in practice, which will not be obvious from disclosures, and might impede comparability.

The IASB could specify more precise requirements

31 If the IASB were to take on a project to amend IAS 37, it could include within that project more precise requirements for identifying the 'best estimate' of the future cash flows for a single liability:

(a) it could require entities to estimate the most likely outcome, or the expected value of the possible outcomes, or some other amount within the range.

(b) it could require the same measures for all types of liability, or permit or require different estimates for liabilities with different distributions of possible outcomes (eg binary distributions, distributions whose outcomes are concentrated on one value, or distributions that are widely dispersed).

We would like your views on whether and how to amend existing requirements

32 To help the IASB reach a preliminary views on this matter, we would like to hear your views on:

(a) whether specifying more precise requirements would improve comparability; and if so

(b) which requirements would produce the most useful information for investors, at a cost that does not exceed the benefits.

33 We will be considering this topic in the break-out sessions, using Case Study 2 in Agenda Paper 3B.