

STAFF PAPER

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IASB Meeting

Project	Research project— IAS 37 Provisions, Contingent Liabilities and Contingent Assets		
Paper topic	Agenda Consultation Feedback		
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Purpose of paper

1. In August 2015, the Board published for comment the Request for Views: *2015 Agenda Consultation* (‘the Request for Views’). Among other things, the Request for Views asked for views on the relative importance and urgency of projects on the Board’s research programme.
2. This paper considers the views received on the research project on *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* (‘the IAS 37 research project’). The paper:
 - (a) provides background information on the purpose and status of the IAS 37 research project (paragraphs 4-9);
 - (b) summarises the feedback received in response to the Request for Views and related online survey (paragraphs 10-21);
 - (c) sets out the staff analysis of the implications of that feedback (paragraphs 22-23); and
 - (d) makes suggestions about the possible next steps for the project and their timing (paragraph 24).

3. This paper does not ask the Board for any decisions. Its purpose is to provide information to help the Board reach decisions on agenda priorities at a future meeting.

Purpose and status of the IAS 37 research project

4. The IAS 37 research project is currently in the assessment stage. The Board has been gathering evidence to help it decide whether to add to its Standards-level programme a project to amend aspects of IAS 37 and if so, what the scope of the project should be.
5. The current research project is *not* a continuation of a previous Board project to amend IAS 37, which was suspended in 2010. The staff have been looking at all of the issues afresh. Although we have made use of evidence gathered in the previous project, we have not presumed that the decisions that the Board reaches in this project will be the same as the proposals it put forward in its previous project. Indeed, the Board could be steered towards quite different decisions by:
 - (a) proposed changes to the *Conceptual Framework for Financial Reporting* ('the *Conceptual Framework*'); and
 - (b) arguments put forward in responses to the previous Exposure Drafts and the current Agenda Consultation.

Most recent Board discussions

6. The Board last discussed the IAS 37 research project in an Education Session at its July 2015 meeting. The Board considered staff analyses of:
 - (a) possible problems with IAS 37; and
 - (b) implications for IAS 37 of the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* ('the *Conceptual Framework* Exposure Draft').¹

¹ Agenda Papers 14-14C, Board meeting, July 2015 - <http://www.ifrs.org/Meetings/Pages/IASB-Meeting-July-2015-a.aspx>

7. The main problems with IAS 37 identified by the staff included:
- (a) two different principles in IAS 37 for identifying liabilities. The principles appear contradictory and have resulted in inconsistent and sometimes unsatisfactory requirements. In particular, IFRIC 21 *Levies*, an interpretation of IAS 37, has been criticised by a range of stakeholders, including users, preparers and auditors of financial statements and national standard-setters.
 - (b) unclear guidance on measurement, which has resulted in diversity in practice. There is diversity in particular in:
 - (i) *the cash outflows included in the measure of a provision*. IAS 37 does not specify whether the measure of a provision should include only cash flows directly related to fulfilment of the liability, or whether it should also include an allocation of other attributable or indirect cash flows. (This question often arises in relation to onerous contract provisions.) IAS 37 is also unclear about whether provisions should include costs payable to third parties, such as legal costs expected to be incurred in negotiating the settlement of a legal claim.
 - (ii) *discount rates*. IAS 37 does not specify whether the rate used to discount future cash flows should take into account the risk of non-performance by the entity (sometimes called the entity's own credit risk). Taking account of the risk of non-performance can substantially reduce the measure of very long-term liabilities (such as decommissioning and environmental rehabilitation obligations).
8. The staff identified a range of possible implications for IAS 37 of the proposals in the *Conceptual Framework* Exposure Draft. The main implications identified were that:
- (a) the proposed concepts could be the basis of clearer general guidance on **identifying liabilities**. The guidance would reconcile, and could replace, seemingly contradictory statements in IAS 37. Application of the guidance could lead to requirements for levies that are different from those in IFRIC 21.

- (b) the proposed concepts could support retaining the existing **recognition criteria** in IAS 37.
- (c) the proposed concepts could help the Board if it decided to develop more specific **measurement requirements** for liabilities within the scope of IAS 37. In particular the proposed concepts suggest that:
 - (i) the Board would focus on ‘fulfilment value’ when developing measurement requirements for IAS 37; and
 - (ii) it could consider whether, and if so how, to customise ‘fulfilment value’ to provide the most useful information about the liability and expenses, and to take into account the cost constraint. Previous stakeholder feedback suggests that if the Board were to take this approach, it might specify a measure that excludes the effects of non-performance risk (and possibly any risk adjustment) and requires outflows of services to be measured at the cost of providing those services (ie without adding the service margin proposed in the previous project).

Subsequent research

9. Since the last Board discussions, the staff have conducted informal outreach with representatives of some accounting firms and preparers of financial statements. Those consulted have tended to say that they do not have many problems applying IAS 37 in practice. Hence, they do not see a need for a fundamental review of the whole Standard. And in particular, they would not wish to see changes to the existing recognition criteria, or more rigid requirements for measuring litigation liabilities. However, some of those consulted identified specific aspects of IAS 37 (such as lack of clarity around discount rates and measurement of onerous contract provisions) for which more guidance could improve application. And some supported changing the requirements for levies.

Responses to the Request for Views and online survey

Request for Views

10. Approximately 60 of the 119 respondents to the Request for Views gave a view on the importance and urgency of the IAS 37 research project, with most (approximately 50) of those respondents providing comments to support their views.

Who thinks this project is important

11. Many of the respondents who ranked this project identified it as being of high or medium importance. These respondents included most of users of financial statements, standard-setters, regulators and accountancy bodies expressing a view. Some of these respondents assigned high importance and urgency to the project, some medium importance and urgency. A few respondents assigned high importance but medium or low urgency.

Why they think it is important

12. Of the respondents who ranked the project as being of high or medium importance, many—including standard-setters, accountancy bodies, regulators, preparers and accounting firms—think that IAS 37 should be updated to reflect the concepts in the revised *Conceptual Framework*, and in particular the new definition of a liability and the new concepts supporting the definition of a liability. (One of the standard-setters said its support for the IAS 37 project as a whole was conditional on the Board retaining the ‘probable outflows’ recognition criterion.)
13. One accountancy body and a European securities regulator specifically referred to a need to address an inconsistency between the concepts proposed for the revised *Conceptual Framework* and the requirements of IFRIC 21. The regulator argued that IFRIC 21 needs to be fundamentally reviewed because it does not lead to relevant information in financial statements. The regulator suggested that, as an alternative to changing the requirements of IAS 37, the Board could consider setting up a separate

research project on non-reciprocal transactions with governments (which could address levies, together with income taxes and government grants). This suggestion is discussed further in Agenda Paper 24F *Agenda Consultation: New topics*.

14. One organisation representing financial analysts commented that, given the broad applicability of IAS 37, it would be useful for the Board to conclude the work it began in its previous project, because of its significant bearing on measurement principles and forward-looking information.
15. Other reasons given for supporting amendments to IAS 37 included:
 - (a) the need to address inconsistencies in practice, and improve application of IAS 37; and
 - (b) a desire to remove inconsistencies between the requirements for contingent liabilities in IFRS 3 *Business Combinations* and those in IAS 37.
16. Two standard-setters noted that the IAS 37 project is closely related to the Board's project on Financial Instruments with Characteristics of Equity. They suggested that the two projects should, therefore, be carried out concurrently.

Who thinks this project is not important

17. Some respondents ranking this project identified it as being of low importance. These respondents included most of the preparers and accounting firms expressing views. They also included some (predominantly European) standard-setters and accountancy bodies.

Why they think the project is not important

18. Of the respondents who identified the project as being of low importance, some—including several accounting firms, a European standard-setter and an organisation representing European preparers of financial statements—argued that they have not encountered significant difficulties applying IAS 37 and, that in their view, IAS 37 (even if not perfect) is operational in practice.

19. Others gave more specific reasons:
- (a) an accountancy body in the Asia-Oceania region expressed a view that concepts for liabilities could be addressed in the *Conceptual Framework*, and hence that a separate project to amend IAS 37 is unnecessary.
 - (b) a body representing preparers of financial statements in the Asia-Oceania region expressed particular concern that the IAS 37 research project could result in the removal of the ‘probable outflows’ recognition criterion from IAS 37.
 - (c) two organisations representing banks expressed concern that the new definition of a liability proposed for the *Conceptual Framework* might have unintended consequences. One suggested that the problems relating to levies could instead be addressed by amending IAS 34 *Interim Financial Reporting*, to allow accrual over the year.

Feedback from online survey

20. Many of the users of financial statements who responded to the online survey expressed a view on the priority of the IAS 37 research project. Of those, many ranked the project as medium priority, some ranked it as high priority and some as low priority. However very few gave any reasons for their rankings.
21. The few who gave reasons to support high priority rankings referred to a need:
- (a) for more robust measurement requirements, stringent rules or clarity; or
 - (b) to review the treatment of changes in provisions. One user commented that the existing requirement to recognise these changes as part of net income ‘ruins the value of net income as a reliable and sustainable figure’.

Staff analysis

22. The staff think that the main messages from the responses to the Request for Views and online survey are that:
- (a) there would be support, especially among standard-setters, for a Standards-level project that focused on incorporating into IAS 37 the concepts for identifying liabilities proposed in the *Conceptual Framework* Exposure Draft (if and when these concepts are finalised), and reviewing IFRIC 21.
 - (b) there would *not* be support, especially among preparers and auditors of financial statements, for a fundamental review of other aspects of IAS 37. In particular, there would not be support for changes to the recognition criteria.
 - (c) assumptions that a project to amend IAS 37 could result in changes similar to those proposed in the previous project are still influencing stakeholders' views about any possible project to amend IAS 37.
23. Thus the staff think that the responses to the Agenda Consultation reinforce the other evidence that has been gathered as part of this research project. The staff think that, taken together, the various pieces of evidence are suggesting that:
- (a) a Standards-level project could result in worthwhile improvements to IAS 37;
 - (b) the scope of the project should be limited to:
 - (i) updating IAS 37 to make its requirements consistent with the definition of a liability and the concepts supporting that definition in the revised *Conceptual Framework*. The main practical implication could be a change in the requirements for levies within the scope of IFRIC 21; and
 - (ii) considering targeted amendments to the measurement requirements (such as specifying whether the discount rate should reflect non-performance risk) to reduce problems arising from diversity in application of the existing requirements.

- (c) the scope of the project should *not* include:
 - (i) a review of the existing recognition criteria; or
 - (ii) consideration of some of the more extensive changes to the measurement requirements that the Board proposed in its previous project to amend IAS 37 (such as the previous proposal to require provisions to include a service margin).

Next steps and timing

24. The staff suggest that:
- (a) the next step on this project would be to compile and document the evidence already gathered in the project.
 - (b) the document could take the form of a Discussion Paper that:
 - (i) summarises the evidence;
 - (ii) gives the Board's preliminary views on whether to add a project to its Standards-level programme and, if so, what the scope of that project should be; and
 - (iii) seeks feedback from the public on those preliminary views.
 - (c) because the main aim of a Standards-level project would be to make IAS 37 consistent with the revised *Conceptual Framework*, the Board would not publish a Discussion Paper on possible amendments to IAS 37 until it had finalised the revisions to the *Conceptual Framework*. Accordingly, no further Board discussions would be needed for this research project until the Board has reached decisions in its *Conceptual Framework* redeliberations.

Questions for the Board

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- 1 Is there any more information you need about the IAS 37 research project to reach decisions on agenda priorities at a future Board meeting?
- 2 Do you have any comments or questions on the material presented in this paper?