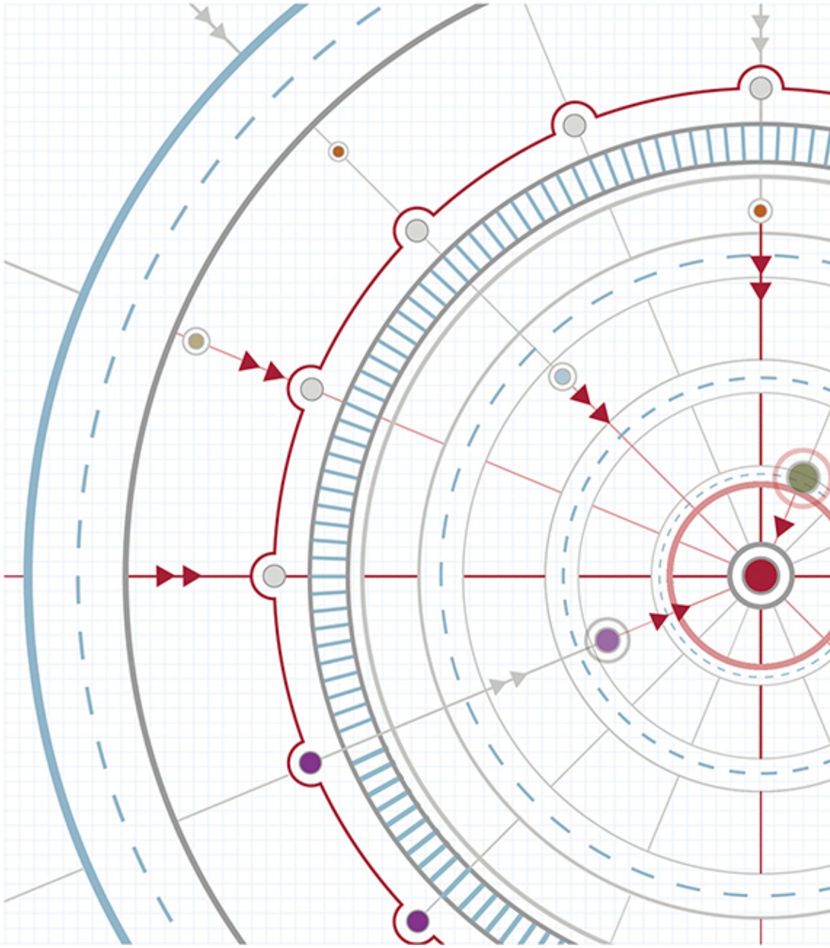

EEG, November 2016
Agenda Paper 1

IAS 37

Provisions, contingent liabilities and contingent assets

Research Programme

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board or IFRS Foundation.

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Objective

Objective of this discussion

- To update you on status of IASB staff research on provisions, contingent liabilities and contingent assets (IAS 37)
- Obtain input from EEG members on most challenging areas of applying IAS 37 Provisions, Contingent Liabilities and Contingent Assets, with specific reference to emerging economies
- To gather your thoughts on:
  - Status of the IAS 37 project
  - Which of a range of possible problems the IASB should address; <u>and</u>
  - what further research/analysis is needed.

Topics for discussion

- Project overview (slides 9–15 and Paper 1A)
- Possible problems with IAS 37 (slides 16-29 and background paper 1B)
- Implications of Conceptual Framework proposals (slides 30-37 and background paper 1C)
- Way forward (Background paper 1D)

The background papers are <u>drawn from</u> papers prepared for discussion at an IASB education session and an ASAF discussion session

Organisation of sessions

- **Session 1 (9:30 – 10:30)**
  - Project overview
  - Paper 1A – Project Overview
- **Summary of questions to be discussed:**
  - Have you followed the IAS 37 discussions previously?
  - Have you identified IAS 37 Application issues in your jurisdiction?
  - Do you think these issues justify an IASB project?

Organisation of sessions

- **Session 2 (10:45 – 12:00)**
  - Identified and perceived concerns
  - Paper 1B – Identified and perceived concerns
- **Summary of questions to be discussed:**
  - Are you familiar with the concerns identified?
  - Are these concerns in your jurisdiction?
  - Are there any concerns we have not covered in the discussion?

Organisation of sessions

- **Session 3 (14:00 – 15:30)**
  - Conceptual Framework
  - Paper 1C – Conceptual Framework
- **Summary of questions to be discussed:**
  - Do you agree further work on IAS 37 should await finalisation of the conceptual framework?
  - Do you agree with the proposed definition of a liability in the conceptual framework?
  - How do you think this definition affects/should affect the work in IAS 37?

Organisation of sessions

- **Session 4 (15:45 – 16:30)**
  - Potential solutions
  - Paper 1D – Agenda Consultation and Way forward
- **Summary of questions to be discussed:**
  - Do you think these issues justify an IASB project (repeat of question in session 1)?
  - Do you have an ideas for project direction?

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Project Overview

Scope of IAS 37

Liabilities
(and possible liabilities)
of uncertain timing or amount
and not within the scope of another Standard

\+ Related reimbursement rights

<u>Provisions</u>
Those that satisfy criteria for recognition

<u>Contingent liabilities</u>
Those that do not satisfy criteria for recognition

Possible assets

<u>Contingent assets</u>
Never recognised

Possible asset or liability = one whose existence is uncertain and will be confirmed only by future event(s).
Example - lawsuit.

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Scope of IAS 37

- Obligations for compensation/fines for breaching laws/regulations
- Asset decommissioning obligations
- Environmental remediation obligations
- Obligations to pay some taxes and levies
- Statutory financial guarantees
- Obligations for costs of restructuring a business
- Warranties of goods sold (other than those sold separately)
- Some onerous contracts
  - Sales contracts within the scope of IFRS 15
  - Contracts for the sale of biological assets and agricultural produce
  - Many contracts for the purchase of goods or services (inventories, PPE, power etc)

Requirements of IAS 37

A. Apply guidance to identify event that creates present obligation or possible obligation ('obligating event').
B. Recognise a provision if three criteria are all met.
C. Disclose a contingent liability if any one of three criteria is not met.
D. Measure at best estimate of expenditure required to settle present obligation…
E. Recognise contingent assets and reimbursement rights only when inflows are virtually certain.

1. Entity has present obligation, or possible obligation that is more likely than not to exist; *and*
2. It is probable that outflow of resources will be required to settle obligation; *and*
3. Reliable estimate can be made of amount of obligation.

Contingent asset is no longer contingent.

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History of IAS 37*

- Started IAS 37 amendment project in 2002, to:
  - align recognition criteria in IAS 37 with those in IFRS 3
  - jointly eliminate unnecessary differences between IFRS and US GAAP
- Used the opportunity to propose other changes to IAS 37, in particular more guidance to support measurement
- Published an ED in 2005 setting out the proposed amendments, and exposed revised measurement proposals in 2010
- There was significant opposition to some proposals in both 2005 and 2010 EDs
- Suspended project in 2010 to allow focus on higher priority projects, and pending completion revisions to Conceptual Framework
- Commenced preliminary work on research project in 2015

* *See also slides 38 to 48*

Research project on IAS 37

- Objective of the research 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.
- 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.

Research project on IAS 37

- Our initial research involved:
  - 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.
- IASB has completed first part of research and has now tentatively decided to wait until it has finalised the Conceptual Framework before progressing to a Discussion Paper

Identified or perceived concerns

Concerns #1
Identifying liabilities

- 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.

Concerns #1
Identifying liabilities

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no **realistic** alternative to settling that obligation.

IAS 37 application guidance – restructuring costs

Only 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.

IFRIC 6 *Waste equipment*

IFRIC 21 *Levies*

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Concerns #2
Recognition criteria

- 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).

Concerns #2
Recognition criteria

1. On basis of available evidence, it is more likely than not that a present obligation exists;

and

2. it is probable (more likely than not) 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.

Concerns #3
Measurement requirements

Lack of clarity in measurement guidance 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?

Concerns #3
Measurement requirements

Existing guidance
Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, … 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.

P	D	K	E
Expected value (EV) might equally apply to a single obligation with various possible outcomes.	EV not valid technique. Often appropriate to provide for whichever possible outcome is closest to expected value.	Usually most likely outcome is best estimate.	The Standard gives no indication of how the increment should be measured.

Concerns #3
Measurement requirements

Example

- Lawsuit: 10% probability of damages of 1 000, 40% probability of damages of 600, 20% probability of damages of 400, 30% probability of claim being dismissed.

Expected Value (P)	Outcome closest to EV (D)	Most Likely Outcome (K)
420	400	600

Concerns #4
Onerous contracts

- 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.

Concerns #4
Onerous contracts

- IAS 37 applies to executory contracts if those contracts are onerous (but not otherwise).
- Onerous contract = contract in which unavoidable costs of meeting obligations exceed the economic benefits expected to be received.
- The unavoidable costs reflect the least net cost of exiting, ie the lower of the cost of fulfilling and the compensation or penalties arising from failure to fulfil.

Concerns #5
Contingent assets

- Threshold for recognising contingent assets is higher than threshold for recognising contingent liabilities
- Users support asymmetry
- 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

Concerns #6
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.

Concerns #7
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.

Concerns #8
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.

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Implications of Conceptual Framework proposals

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Conceptual Framework proposals

The proposed concepts could:

- lead the IASB to different conclusions from those in previous project to amend IAS 37.
- lead to different requirements for levies from those in IFRIC 21.
- lead to differently-worded requirements for restructuring costs (but possibly not differences in practice for many restructuring costs).
- help to rationalise the existing recognition criteria in IAS 37.
- help the IASB if it decided to develop more precise measurement requirements. It could lead the IASB to:
  - focus on fulfilment value
  - consider whether and how to modify to enhance relevance and faithful representation of liabilities and expenses, and to take into account cost constraint.

Conceptual Framework proposals
Definition of liability

	Existing definitions	Exposure Draft
Liability (of an entity)	A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	Not defined	A right that has the potential to produce economic benefits.

Conceptual Framework proposals
Present obligation

- Examples that have proved problematic:
  - Constructive obligations – because of customary practices, published policies or specific statements, an entity has no practical ability to avoid transfer of economic resources
  - An entity has right to take action to avoid transfer of economic resources, but no practical ability to take that action
- Entity might have no practical ability to avoid a transfer if, eg:
  - Alternative courses of action would cause significant business disruption or have economic consequences significantly more adverse than the transfer itself
  - The transfer could be avoided only by liquidating the entity or ceasing trading

Conceptual Framework proposals
Present obligation

Present obligation to transfer an economic resource

No practical ability to avoid the transfer	AND	The amount is determined by reference to past activities or benefits received

Consider in Standards

Conceptual Framework proposals
Identifying liabilities

	IAS 37	Conceptual framework
Levies	• IFRIC 21 identifies liabilities when obligation becomes unconditional • Can result in liability & expense recognised only at point in time • Some think IFRIC 21 does not faithfully represent periodic levies	Concepts identify a liability if: • no practical ability to avoid; and • received benefits or conducted activities that establish extent of obligation. Applying concepts, liabilities for <u>accumulating periodic levies</u> recognised incrementally over period
Restructuring costs	• IAS 37 identifies liabilities when an entity has announced a restructuring plan • There are different views on whether an announcement creates an obligation	• The proposed concepts could reconcile the different views • The practical implications might not be great.

Conceptual Framework proposals
Recognition criteria

IAS 37	Conceptual framework
• 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 Exposure Draft proposed 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.

Conceptual Framework proposals
Measurement

IAS 37	Conceptual framework

• 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.
	Proposed concepts could lead to conclusions that differ from previous
	• IASB may focus on ‘fulfilment value’ when developing measurement requirements for IAS 37
	• IASB may consider whether and how to customise ‘Fulfilment Value’. For example:
	    • not requiring ‘expected value’ estimates in all circumstances;
	    • excluding effects of non-performance risk;
	    • requiring outflows to be measured at cost

Previous proposals

Previous proposals
Exposure Drafts 2005 and 2010

Rationale	Proposal
Short-term convergence	• Align requirements for restructuring costs (including employment and other contract termination costs) with US GAAP

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Exposure Drafts 2005 and 2010

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Reflect concepts developed in business combinations project	• Require recognition of liabilities (& reimbursement rights) that exist and can be measured reliably, remove probable outflows recognition criterion • Clarify that liabilities include obligations to stand ready • Eliminate term ‘contingent liability’ • Remove requirements for contingent assets

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Clarify measurement requirements	• Measure liabilities at amount entity would rationally pay to transfer or settle obligation at reporting date • To meet this objective, measure future outflows at ‘expected value’ • Measure outflows of services at value (not cost) of those services

Measurement
IAS 37 requirements

36. **The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.**
37. The best estimate of the expenditure required to settle the present obligation 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.
38. 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.

Measurement
IAS 37 requirements

36. The amount recognised as a provision shall be ~~the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.~~ ~~The best estimate of the expenditure required to settle the present obligation 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.

40 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.~~ an expected value approach would be appropriate. In contrast, measuring a single obligation at its most likely outcome would not necessarily reflect the amount the entity would rationally pay to settle or transfer the obligation.

Previous proposals
Exposure Drafts 2005 and 2010

Rationale	Proposal
Short-term convergence	• Align requirements for restructuring costs (including employment and other contract termination costs) with US GAAP
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	• Codify practice – define scope to include all liabilities not within the scope of another Standard and eliminate term ‘provision’. • Re-write as an IFRS.

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