STAFF PAPER

January 2020

IASB® meeting

Project	**Provisions**
Paper topic	Research summary

CONTACTS	Anuj Deuba	adeuba@ifrs.org	+44 (0)20 7246 6413
	Joan Brown	jbrown@ifrs.org	+44 (0)20 7246 6916

Introduction

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies to all liabilities of uncertain timing and amount (provisions) not within the scope of another IFRS Standard, and all contingent liabilities not within the scope of another IFRS Standard. These liabilities and contingent liabilities include, for example:

(a) obligations, and possible obligations, to pay compensation or fines for acts of wrongdoing;

(b) obligations to decommission plant or equipment at the end of its useful life, to dispose of waste products or to rectify environmental damage;

(c) obligations for some costs of restructuring a business;

(d) obligations to pay some taxes and levies;

(e) warranties of goods sold to customers;

(f) statutory financial guarantees; and

(g) some onerous contract obligations.

IAS 37 also applies to contingent assets and rights to reimbursement for the costs of settling any liabilities within the scope of IAS 37.

Stakeholders often report that in general they do not encounter major problems applying IAS 37. However, some stakeholders have suggested some aspects of IAS 37 are deficient and asked the International Accounting Standards Board (Board) to consider amending those aspects.

The Board already has on its work plan a project to make one narrow-scope amendment to IAS 37—to clarify which costs an entity includes in assessing whether a contract is onerous. In this research project, we have considered the other aspects of IAS 37 that stakeholders have suggested are deficient. For each one we have gathered evidence to help the Board decide:

(a) whether, applying that aspect of IAS 37, there is a deficiency in the way transactions or activities are reported in financial reports;

(b) if so, how much of an impact that deficiency has in practice—how pervasive and acute the matter is for entities and how important it is to users of financial statements; and

(c) whether and how the Board could amend IAS 37 to address the deficiency—including how it might now be assisted by the *Conceptual Framework for Financial Reporting* issued in March 2018 (*Conceptual Framework*).

Each section of this paper discusses one aspect of IAS 37 and summarises the evidence gathered. The evidence in each case includes stakeholder feedback obtained at various times during the research project. Appendix A explains the purpose and scope of each consultation and provides links to more detailed reports of the feedback received.

In several places in this paper the staff refer to a previous project to amend IAS 37. In that previous project, the Board developed proposals for a range of amendments to IAS 37.[1] The Board halted the project in 2010 without making any amendments. This research project is not a continuation of the previous project, but the staff have drawn upon evidence gathered during that project.

1 IASB completed projects Liabilities (Amendments to IAS 37)

TABLE OF CONTENTS

1 Liability definition and requirements for identifying liabilities

IAS 37 requirements seem contradictory and inconsistent with those in other IFRS Standards

1.1 IAS 37 specifies that a provision must meet the definition of a liability. To meet this definition, an entity must have a 'present obligation'. IAS 37 includes requirements for identifying present obligations. However, stakeholders have identified apparent contradictions within those requirements:

(a) on one hand, paragraph 19 of IAS 37 states that it is only obligations 'existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions'. This statement is often interpreted as meaning that liabilities must be unconditional—an entity *does not* have a liability for obligations that it could avoid through its future actions, even if those future actions are unrealistic.

(b) on the other hand, paragraph 10 of IAS 37 defines an obligating event as an event that 'results in the entity having no realistic alternative to settling the obligation'. This statement is often interpreted as meaning that an entity *does* have a liability for obligations that could be avoided through its future actions, *if* those actions are unrealistic.

1.2 Consequently, it is unclear how unavoidable an obligation must be. This lack of clarity has given rise to problems in practice. In response to requests for more guidance, the IFRS Interpretations Committee issued two Interpretations: IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* and IFRIC 21 *Levies*. In both cases, the Committee applied paragraph 19 of IAS 37 and concluded that an entity does not have a present obligation if it could avoid the transfer through its future actions (even if those actions are unrealistic).

1.3 However, the Interpretations have not resolved the matter:

(a) the Interpretations appear inconsistent with other requirements in IAS 37, especially requirements for restructuring costs. IAS 37 requires entities to recognise liabilities for restructuring costs when they have announced or started to implement a restructuring plan. The rationale is that, once an entity has announced or started to implement a plan, it has no realistic alternative other than to complete the plan. It is unclear why one principle applies to levies and another to restructuring costs. Consequently, it is unclear which principle should apply to other transactions within the scope of IAS 37, but not specifically discussed there.

(b) IFRIC 21 has been criticised by a range of stakeholders, including users, preparers and auditors of financial statements and national standard setters. IFRIC 21, in combination with IFRS Standards addressing the identification and recognition of assets (such as IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*), results in some recurring periodic levies being recognised as expenses at a single point in time. Stakeholders have expressed concern about this outcome because they believe that the economic substance of a recurring levy is that the entity is paying to operate over a period, and that this substance would be more faithfully represented by spreading the expense over the period to which the levy refers.

(c) the requirements of IFRIC 21 are not consistent with the requirements of other IFRS Standards that address similar issues. As a result, IAS 37 now appears to be inconsistent with those other Standards. For example, IFRS 2 *Share-based Payments* addresses liabilities for cash-settled share-based payments. It requires an entity to recognise a liability when it receives the goods or services acquired in exchange for a share-based payment—even if at that time the payment is still subject to vesting conditions. Vesting conditions could include future performance targets, such as increases in revenues or profits. In such situations, the liability is recognised even when the entity could still, in theory at least, avoid the payment through its future actions.

Concepts in the Conceptual Framework provide a basis for more consistent requirements

1.4 The seeming contradictions in IAS 37 highlight a question the board has had to contend with on a range of different projects over the years—whether, and if so when, an obligation conditional on the entity's future actions is a 'present' obligation. Because the same question arises for many different types of transaction—not only those within the scope of IAS 37—the Board decided to answer it at a conceptual level, as part of its *Conceptual Framework* project. As a result, the *Conceptual Framework* now contains concepts that address this matter.

1.5 The *Conceptual Framework* defines a liability as 'a present obligation of the entity to transfer an economic resource as a result of past events' and states that:

> 4.27 For a liability to exist, three criteria must all be satisfied:
>
> (a) the entity has an obligation;
>
> (b) the obligation is to transfer an economic resource; and
>
> (b) the obligation is a present obligation that exists as a result of past events.

1.6 The *Conceptual Framework* defines an obligation as 'a duty or responsibility that an entity has no practical ability to avoid' and addresses situations in which that duty is conditional on the entity's own future actions:

> 4.32 In some situations, an entity's duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business or operating in a particular market on a specified future date, or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action.

1.7 The *Conceptual Framework* also states that:

> 4.43 A present obligation exists as a result of past events only if:
>
> (a) the entity has already obtained economic benefits or taken an action; and
>
> (b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

1.8 The Board could apply these concepts to specify new requirements in IAS 37 for obligations conditional on the entity's own future actions. The Board could specify that the entity has a liability if both:

(a) it has received economic benefits and, as a consequence, will or may have to transfer an economic resource it would not otherwise have had to transfer; and

(b) it has no practical ability to avoid the future actions that would trigger the transfer.

Applying the concepts could change the timing of recognition of some levies

1.9 IFRIC 21 addresses levies that become payable only when a series of activities have all occurred. It applies the principle in paragraph 19 of IAS 37 that an obligation must exist independently of the entity's future actions. IFRIC 21 states that the event that gives rise to an obligation to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. There may be earlier activities that are also *necessary* for a levy to be payable, but because they are not *sufficient* by themselves to trigger the payment, they are not obligating events.

1.10 If the Board were to develop new requirements for IAS 37 based on the *Conceptual Framework*, it could specify requirements different from those in IFRIC 21. A liability might be identified as existing before the entity conducts the activity that triggers the payment of the levy. It would be identified as existing earlier if:

(a) before the activity that triggers payment, the entity has received economic benefits or conducted other activities that mean it may have to pay a levy; and

(b) it has no practical ability to avoid the activity that triggers payment.

Furthermore, the liability may come into existence progressively over time if the activity that determines the amount of the liability takes place over time.

Applying the concepts would not necessarily change the timing of recognition of other provisions

1.11 In July 2015, the Board discussed what implications the (then draft) concepts would have for restructuring provisions and obligations of the type addressed by IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*.[2] In October 2016, the Board discussed the implications of the (still draft) concepts for other transactions specifically illustrated in IAS 37—including product warranties, a contaminated land obligation, a court case, a legal requirement to fit smoke filters and asset refurbishment costs.[3]

1.12 The staff concluded that in each case, the outcome of applying the concepts would typically be the same as the outcome of applying existing IAS 37 requirements.

But the requirements might be easier to apply to transactions not specifically discussed in IAS 37

1.13 Although the staff concluded that the outcome would typically remain the same, we noted that, in some cases, the reasoning would be different. For example, slightly different reasoning would be needed to explain why the announcement or implementation of a restructuring plan gives rise a liability for the costs of restructuring. The staff think changing the reasoning would eliminate the seeming contradictions in IAS 37. This would in turn make the requirements clearer, and easier to apply to the new types of obligations that can emerge from time to time, for example as a result of new laws.

---

2 IASB meeting July 2015, Agenda Paper 14C *Implications of Conceptual Framework proposals*, paragraphs 1.20–1.34.

3 IASB meeting October 2016, Agenda Paper 10C *Testing the proposed asset and liability definitions—illustrative examples*.

Feedback suggests resolving this matter is important to stakeholders

1.14 Stakeholders have consistently identified the requirements of IFRIC 21 as one of the most important deficiencies in IAS 37 and supported suggestions the Board could align the IAS 37 requirements for identifying liabilities with the *Conceptual Framework*.

The Board could update the IAS 37 liability definition at the same time

1.15 IAS 37 defines a liability using a definition from an old version of the *Conceptual Framework*:

> A liability is 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.[4]

1.16 Paragraph 4.2 of the *Conceptual Framework* now defines a liability as:

> A present obligation of the entity to transfer an economic resource as a result of past events.

1.17 If the Board aligns the IAS 37 requirements for identifying liabilities with the *Conceptual Framework*, it could at the same time could update the liability definition.

1.18 None of the requirements in IAS 37 depend on aspects of the definition that would change, so we think updating the definition would not require any other consequential amendments to IAS 37.

4 Paragraph 10 of IAS 37.

2 Recognition criteria for providers

Probable outflows recognition criterion?

IAS 37 has three recognition criteria for provisions

2.1 IAS 37 was developed to address liabilities subject to uncertainty. Some of those liabilities (for example 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 (for example a possible liability to pay damages for an alleged act of wrongdoing) are also subject to 'existence uncertainty'—even the existence of the liability is uncertain, often disputed, and will be confirmed only on the occurrence of a future event, such as a court ruling.

2.2 IAS 37 addresses existence and outcome uncertainty by requiring entities to recognise liabilities if three criteria are all met:

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

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

(c) if a reliable estimate can be made of the amount of the obligation.[5]

In a previous project the Board proposed to remove the probable outflows criterion

2.3 In a previous project to amend IAS 37, the Board proposed to remove the probable outflows recognition criterion from IAS 37.[6] Its reasons were that:

5 Paragraphs 14, 15 and 23 of IAS 37.

6 Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, June 2005

(a) other IFRS Standards (such as IFRS 3 *Business Combinations* and IFRS 9 *Financial Instruments*) do not include that criterion.

(b) recognition of a liability 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 cash flows.

(c) financial statements are not complete if they omit some of an entity's liabilities.

(d) if there is a low probability of a future outflow, that factor can be reflected by measuring the liability at an amount that reflects the low probability. (The Board also proposed to require provisions to be measured at the expected value (probability weighted average) of the possible outcomes, and viewed a probable outflows recognition threshold as inconsistent with that measurement basis.)

2.4 However, many stakeholders opposed the proposal to remove the probable outflows criterion, arguing that it serves a useful purpose in IAS 37 because, in their view:

(a) recognition of provisions for which there is only a low probability of a cash outflow does not provide relevant financial information. Information about the range of possible and outcomes and the uncertainties is most useful.

(b) the costs incurred by preparers of financial statements to recognise and measure low probability provisions would outweigh the benefits to users. The cost of identifying all the possible outcomes and estimating the probability of each is disproportionate to the amounts likely to be recognised.

(c) the probable outflows criterion can be a helpful filter that avoids the need for consideration of whether a liability exists. In its absence, IAS 37 would be more complex to apply, leading to greater diversity.

(d) without the probable outflows criterion, entities might need to identify and recognise provisions for undetected acts of wrongdoing. Recognition would increase the risk of future detection and prejudice the outcome of any action taken against the company.

(e) consistency with other standards, such as IFRS 3, is not important. Differences in the nature of the transactions—especially for assets and liabilities acquired in a business combination—justify different requirements. The different criteria have not caused major problems for users or preparers of financial statements.

(f) the probable outflows criterion was required by the version of the *Conceptual Framework* in issue that time. Any revisions to IAS 37 should be postponed until the Board had completed its project to revise the *Conceptual Framework*.

The Conceptual Framework does not indicate a need to remove the probable outflows criterion

2.5 The Board completed its project to revise the *Conceptual Framework* by issuing a revised version in March 2018.

2.6 The current version now envisages that not all assets and liabilities will be recognised, and that recognition criteria may vary between IFRS Standards. It specifies that an asset or liability is recognised only if:

(a) recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful; and

(b) if the benefits of the information provided to users of financial statements by recognition are likely to justify the costs of providing and using that information. In some cases, the costs of recognition may outweigh its benefits.[7]

2.7 The *Conceptual Framework* discusses assets and liabilities for which the probability of an inflow or outflow of economic benefits is low:

> 5.16 If the probability of an inflow or outflow of economic benefits is low, the most relevant information about the asset or liability may be information about the magnitude of the possible inflows or outflows, their possible timing and the factors affecting the probability of their occurrence. The typical location for such information is in the notes.

/continues

[7] Paragraphs 5.7 and 5.8 of the *Conceptual Framework*.

5.17 Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or liability may provide relevant information beyond the information described in paragraph 5.16. Whether that is the case may depend on a variety of factors. For example:

(a) if an asset is acquired or a liability is incurred in an exchange transaction on market terms, its cost generally reflects the probability of an inflow or outflow of economic benefits. Thus, that cost may be relevant information, and is generally readily available. Furthermore, not recognising the asset or liability would result in the recognition of expenses or income at the time of the exchange, which might not be a faithful representation of the transaction (see paragraph 5.25(a)).

(b) if an asset or liability arises from an event that is not an exchange transaction, recognition of the asset or liability typically results in recognition of income or expenses. If there is only a low probability that the asset or liability will result in an inflow or outflow of economic benefits, users of financial statements might not regard the recognition of the asset and income, or the liability and expenses, as providing relevant information.

2.8 Liabilities within the scope of IAS 37 often arise from an event that is not an exchange transaction, meaning that paragraph 5.17(b) would often apply. Furthermore, the absence of an exchange transaction means there is no observable historical transaction price for such a liability. And the liabilities tend not to be traded, so tend not have an observable current market price either. The absence of any observable price could justify recognition criteria in IAS 37 different from those in other IFRS Standards. In particular, it might justify recognition criteria to filter out liabilities whose existence or outcome is highly uncertain, or for which there is a low probability of future outflows.

Stakeholders do not think the criterion should be removed

2.9 To justify changing the recognition criteria in IAS 37, the Board would need to demonstrate why and how the existing criteria are deficient.

2.10 We have consulted stakeholders on this question on several occasions during this research project, most directly at a joint meeting of the Global Preparers Forum and Capital Markets Advisory Committee in 2015.[8] Stakeholders have not identified deficiencies—they have generally expressed strong support for retaining the existing recognition criteria for the reasons listed in paragraph 2.4.

Comparison with US GAAP

IAS 37 recognition thresholds were identified as a challenge to US adoption of IFRS Standards

2.11 In 2009, the US Financial Accounting Standards Board (FASB) identified IAS 37 as an IFRS Standard it thought might be difficult to apply in the United States, and so would be a potential challenge to US adoption of IFRS Standards.[9]

2.12 The FASB's concern stemmed from differences between the recognition criteria in IAS 37 and those in US generally accepted accounting principles (US GAAP). Applying US GAAP, an entity recognises a loss contingency if it is 'probable' that a liability has been incurred and that amount can be reasonably estimated.[10] However, for entities defending lawsuits, 'probable' is interpreted applying US GAAP as a higher threshold than the 'more likely than not' threshold in IAS 37: the American Bar Association's *Statement of Policy Regarding Lawyers Responses to Auditors' requests for Information*

[8] As detailed further in the documents linked to paragraph A2 of the appendix to this paper.

[9] Financial Accounting Foundation and FASB response to the SEC's *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards (IFRS) by US Issuers*. Response dated 11 March 2009.

[10] FASB Accounting Standards Codification, Section 450-20-25 (the Recognition Section of the Loss Contingencies Subtopic of the Contingencies Topic).

defines probable to include only those ‘relatively few clear cases’ in which ‘the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight’.

2.13 Consequently, the threshold applied in IAS 37 for recognising litigation liabilities (more likely than not) may be lower in practice than the threshold applied in US GAAP (prospects of success are slight). Applying the lower IFRS threshold, US entities would recognise liabilities for cases that they were continuing to defend. US companies have reported concerns that attorney-client privilege could be lost for information that lawyers would need to give auditors to support the amounts recognised. It could then be subject to discovery by adversaries, prejudicing the outcome of the lawsuit.

But we have no reports of problems in practice for entities applying IFRS Standards

2.14 Many entities that apply IFRS Standards have operations in the US, and are required to defend litigation within the US legal system. However, the Board has not received any reports that such entities are encountering practical problems any greater than those encountered by entities applying US GAAP.

3 Requirements for measuring provisions

3.1 The measurement requirements in IAS 37 are less specific than those in some other IFRS Standards. As a result, entities have more flexibility in the accounting policies they develop for measuring provisions than in the policies they develop for measuring some other liabilities.

3.2 The evidence gathered in this project suggests that:

(a) stakeholders regard some aspects of that flexibility as important because IAS 37 addresses diverse types of liabilities, which are often non-routine in nature and subject to different types and degrees of measurement uncertainty; but

(b) lack of specific requirements in some areas gives rise to problems in practice.

3.3 The rest of this section discusses aspects of the measurement requirements that are less specific than those in other IFRS Standards and the evidence we have gathered about whether adding more specific requirements would result in more useful information for users of financial statements—and whether the benefits of imposing extra specificity would justify the costs.

Best estimate

Existing IAS 37 requirements for single obligations are unclear

3.4 Paragraph 36 of 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'. Paragraph 37 adds that this amount 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'.

3.5 IAS 37 discusses how entities should identify the 'best estimate' of a liability with a range of possible future cash flows. For large populations, it is clear. It states that:

> 39 … 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'.

3.6 However, for single obligations, it is less clear. It states that:

> 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.
> …

3.7 This paragraph seems to say that the most likely outcome is an appropriate measure only if that outcome is reasonably close to the expected value of the possible outcomes, or the median outcome of the range. However, the guidance fails to specify how the cash flows should be measured in any other circumstances.

Entities may adopt different approaches

3.8 Some people think that the measurement objective in IAS 37 implies that even single obligations should be measured using the expected value (probability-weighted average) of the possible outcomes. They reason that this measure is necessary to comply with paragraph 37 of IAS 37—an estimate of the amount an entity would rationally pay to settle a liability or transfer it to another party at the end of the reporting period would take into account all possible outcomes and their probabilities.

3.9 However, views diverge. The IFRS manuals published by the four largest accounting firms variously advise that:

(a) although the example in IAS 37 applies the expected value method to a large population of similar claims, that method might equally be applied to a single obligation with various possible outcomes.[11]

(b) expected value is *not* a valid technique for single obligations. Generally, if the most likely outcome is close to the expected value, it will be appropriate to provide for the most likely outcome. Otherwise, it will often be appropriate to provide for whichever possible outcome is nearest to the expected value.[12]

(c) usually the most likely outcome is the best estimate of a single obligation. (An example illustrates a liability with two possible outcomes. It identifies the more likely of the two outcomes as the best estimate of a liability, and states that the expected value would not be the best estimate of the liability.)[13]

(d) although IAS 37 provides an example of a case in which the best estimate of a single obligation might have to be larger than the individual most likely outcome, it gives no indication of how this increment should be determined.[14]

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

The Board could specify more precise requirements

3.11 The Board could specify more precise requirements for identifying the 'best estimate' of the future cash flows for a single obligation:

(a) it could specify whether entities are required to estimate the most likely outcome, the expected value of the possible outcomes, the median point of the range, or some other amount.

(b) it could require the same estimate for liabilities within the scope of IAS 37, 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).

11 PwC IFRS *Manual of Accounting*, 2019, paragraph 16.47.
12 Deloitte *iGAAP* 2019, Volume A, Chapter A12, Section 4.2.2.
13 KPMG *Insights into IFRS*, 2019/20, paragraph 3.12.110.30.
14 EY *International GAAP*, 2020, Chapter 26, section 4.2.

3.12 There are precedents. IFRS 15 *Revenue from Contracts with Customers* requires entities to estimate variable consideration at either its expected value or most likely outcome, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. IFRIC 23 *Uncertainty over Income Tax Treatments* has similar requirements for uncertain tax treatments. Both IFRS 15 and IFRIC 23 give examples of circumstances in which each method may better predict the outcome.

But feedback suggests stakeholders support the existing flexibility

3.13 Feedback we have gathered both before and during this project suggests that most stakeholders—including users of financial statements—do not want more precise requirements in this area, and in particular would oppose requirements to measure all provisions by estimating the expected value of the possible outcomes.

3.14 In a previous project to amend IAS 37, the Board proposed to require all provisions to be measured by estimating the expected value of the cash flows.[15] Most respondents opposed this proposal, reasoning that for single obligations:

(a) expected values are not relevant measures of single obligations. They do not provide a prediction of the outcome and require liabilities with binary outcomes to be measured at an amount that will never be paid in any circumstances (an amount that is inevitably ‘wrong’).

(b) it is not possible to provide a faithful representation of the expected value of some liabilities within the scope of IAS 37. Even simple lawsuits can involve many variables, some of which can be highly unpredictable. Expected value techniques should be used only when the characteristics of the item being measured are amenable to statistical estimation. Errors in expected value can be highly sensitive to changes in the probabilities of extreme outcomes, so expected value measures provide more scope for manipulation.

15 Exposure Draft *Measurement of Liabilities in IAS 37*, January 2010

(c) the costs of estimating the expected value of some provisions would be higher than the costs of estimating the most likely outcome, and the additional costs would outweigh the benefits.

(d) a requirement to measure provisions at their expected value could increase the practical difficulties for entities defending lawsuits in the US. Information about the possible outcomes shared with auditors may lose its attorney-client privilege and the provision recognised may be viewed as a 'floor' by the counterparty, leaving an entity will little or no ability to negotiate a lower settlement.[16]

3.15 We also consulted preparers and users of financial statements at a joint meeting of the Global Preparers Forum and Capital Markets Advisory Committee (CMAC) in 2015. We asked participants for their views on whether the Board should specify how to measure the best estimate of a litigation provision, and if so, which measure it should specify. Members of both groups agreed that:

(a) the most useful information about litigation is information disclosed in the notes, especially information that indicates the range of possible outcomes and the potential for any recoveries.

(b) IAS 37 should continue to allow management to apply judgement to decide which measure provides the best estimate of the outcome—it should not specify any single measure. CMAC members did not think that it was a problem that entities might report different amounts, assuming entities also disclosed enough narrative information about the basis of measurement and the uncertainties around the outcome.[17]

16 IASB September 2010 meeting, Agenda Paper 7 (Appendix) *Comment letter summary—Main issues*, section 3.3.

17 As detailed further in the documents linked to paragraph A2 of the appendix to this paper.

Expenditure—costs to include

IAS 37 has been silent and practices diverge

3.16 Many IFRS Standards require entities to measure non-monetary assets or liabilities by reference to the costs they have incurred to purchase or manufacture an asset, or the costs they will incur to fulfil a liability. Most of those Standards specify the types of costs that should be included, for example whether the costs should include only the incremental costs of manufacturing an asset or providing goods required to fulfil a liability, or whether the costs should also include other directly related costs (eg production overheads). Several Standards also list examples of the types of costs that should or should not be included.[18]

3.17 In contrast, IAS 37 has been silent on what it means by 'expenditure', leaving scope for diversity in practice. It is unclear, for example, how entities should measure expenditure required to settle obligations to provide goods (such as inventories) or services (such as decommissioning or environmental rehabilitation). Some people have taken the view that only incremental costs should be included in any provision.

3.18 IAS 37 is also unclear about whether the expenditure required to settle a provision includes costs payable to third parties, such as legal costs expected to be incurred in negotiating the settlement of a legal claim.

A forthcoming amendment to IAS 37 might reduce diversity but the requirements would remain unclear

3.19 The Board has recently approved a narrow-scope amendment to IAS 37, effective for annual reporting periods beginning on or after 1 January 2022. This narrow-scope amendment will clarify which costs an entity includes in assessing whether a contract is onerous, and hence in assessing whether the entity needs to recognise an onerous contract provision. The amendment will clarify that an entity should include both:

[18] See for example: paragraphs 95–98 of IFRS 15 *Revenue from Contracts with Customers*, paragraphs 10-16 of IAS 2 *Inventories* and paragraphs 16-22 and IAS 16 *Property, Plant and Equipment*.

(a) the incremental costs of fulfilling the contract—for example direct labour and materials; and

(b) an allocation of costs that relate directly to fulfilling that contract and others—for example an allocation of depreciation of equipment used in contract activities.[19]

3.20 The clarification will be sited within the requirements to recognise provisions for onerous contracts—not within the measurement requirements. Preparers of financial statements might reasonably decide that the same costs should also be used to measure any onerous contract provision recognised, and perhaps to measure all other types of provisions for obligations to provide goods or services. However, without an explicit statement to this effect, the measurement requirements may remain unclear.

More explicit requirements would provide greater clarity

3.21 The Board could resolve the uncertainty by clarifying whether the requirements for recognising onerous contract provisions also apply to measuring those and other provisions. To make the requirements consistent, the Board could specify that the expenditure required to settle a provision includes all costs that relate directly to fulfilling the obligation.

Discount rates—own credit risk

IAS 37 does not specifically address own credit risk

3.22 IAS 37 requires entities to discount estimates of future cash flows to their present value, and states that the discount rate should reflect 'current market assessments of the time value of money and the risks specific to the liability'.[20]

3.23 IAS 37 does not give specify whether the rate should reflect the entity's own credit risk, that is the possibility the entity may fail to fulfil its obligation. An entity can reflect its own credit risk by discounting a liability at its borrowing rate instead of a (lower) risk-free rate.

[19] IASB Implementation project Onerous Contracts—Cost of Fulfilling a Contract.
[20] Paragraphs 45–47 of IAS 37.

Diversity in practice leads to significant loss of comparability in sectors affected

3.24 Evidence of diversity in practice was submitted to the IFRS Interpretations Committee in 2010, along with a request for clarification. The Committee decided the request for would best be addressed as part of the Board's then project to replace IAS 37. In reporting its decision, the Committee said it understood that the predominant practice at that time was to exclude own credit risk, which it said was generally viewed in practice as a risk of the entity rather than a risk specific to the liability'.[21]

3.25 However, not all stakeholders agree with this view. Some think the inclusion of own credit risk is consistent with the measurement objective expressed in paragraph 37 of IAS 37. This paragraph states that that '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'. Some stakeholders suggest that the amount an entity would rationally pay is the amount the counterparty would require it to pay, which would reflect the entity's own credit risk.

3.26 IASB staff research indicates that practices continue to diverge. The predominant practice still appears to be for entities to exclude their own credit risk from discount rates. However, some entities—concentrated in particular jurisdictions and sectors—include own credit risk, discounting long-term liabilities using their borrowing rate, instead of a risk-free rate, and reporting smaller liabilities as a result. For entities with large, long-term decommissioning or environmental rehabilitation provisions—for example those in power supply and extractive industries—the difference can have a substantial effect on their reported financial position and performance, leading to significant loss of comparability between entities.

Feedback suggests this matter is important to stakeholders

3.27 Feedback obtained throughout this research project indicates that stakeholders, and especially users of financial statements, regard this issue as important because, for the

21 Agenda decisions section of IFRIC *Update*, March 2011.

sectors affected, the diversity in practice causes substantial differences in the amounts different entities report in their financial statements.

3.28 Almost all stakeholders who expressed a view said they think IAS 37 should prohibit the inclusion of own credit risk. Users of financial statements reasoned that including an entity's own credit risk:

(a) impairs comparability;

(b) produces counter-intuitive results—higher risk entities would recognise smaller provisions;

(c) creates volatility; and

(d) does not provide them with useful information if an entity is a going concern.

Risk adjustments

IAS 37 requirements for risk adjustments are unclear

3.29 IAS 37 states that:

> **42 The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.**
>
> 43 Risk describes variability of outcome. A risk adjustment may increase that amount at which a liability is measured. …

3.30 IAS 37 does not identify the precise objectives of the risk adjustment, or clarify the circumstances in which a risk adjustment is required, or explain how a risk adjustment should be measured. Some people think that a risk adjustment is required only if the cash flows are measured at their most likely outcome—the purpose of the adjustment being to reflect other possible outcomes. Others think that a risk adjustment may also be required if cash flows are measured at their expected value—the purpose being to reflect the price of bearing the risk that the cash flows will differ from those expected.

The Board could add the description used in other IFRS Standards

3.31 Other IFRS Standards that require risk adjustments, such as IAS 36 *Impairment of Assets*, IFRS 13 *Fair Value Measurement* and IFRS 17 *Insurance Contracts*, are clearer. They all describe the risk adjustment they require as being the price (or compensation required) for bearing the uncertainty inherent in the future cash flows.[22] They require a risk adjustment even when cash flows are measured at their expected value—the risk adjustment reflects the risk that the cash flows might ultimately differ from those expected.

Or IAS 37 could require entities to measure provisions without a risk adjustment

3.32 In a previous project to amend IAS 37, the Board proposed to clarify the purpose of the risk adjustment.[23] However, many respondents—including most of the user groups and auditors commenting—expressed concerns about the proposal, particularly because the Board did not include guidance on how to measure the risk adjustment. Some respondents questioned whether entities can reliably measure risk adjustments for liabilities within the scope of IAS 37, noting that methods used by insurers for large pools of risks cannot be applied to single obligations. Some respondents suggested that a requirement to add a risk adjustment might give managers unwarranted latitude to manipulate the liability, reducing comparability. Some suggested that users would be better served by disclosure of the risks and the range of possible outcomes—they could use these disclosures to make adjustments that appropriately reflect their own risk preferences.[24]

But stakeholders have not identified this matter as important

3.33 The IAS 37 requirements for risk adjustments are unclear. But we are not aware of stakeholders having identified specific pervasive and acute practical problems arising as a result. Stakeholders expressed concerns only when, in a previous project to amend IAS 37, the Board included proposals to clarify the risk adjustment requirements among proposals for other significant changes to the IAS 37 requirements.

---

22 Paragraph 30 of IAS 36, paragraph B13 of IFRS 13 and paragraph 37 of IFRS 17.

23 Exposure Draft *Measurement of Liabilities in IAS 37*, January 2010

24 IASB September 2010 meeting, Agenda Paper 7 (Appendix) *Comment letter summary—Main issues*, section 3.5

Measurement objective

IAS 37 lacks a clear measurement objective

3.34 The measurement objective in IAS 37 is not clear. Paragraph 36 of IAS 37, which requires an entity to measure a provision at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period seems to imply a 'fulfilment value' measurement objective. In contrast, paragraph 37 of IAS 37, which states that this best estimate may be the amount the entity would rationally pay to transfer the obligation to a third party at the reporting date, suggests some sort of transfer value.

Some stakeholders have suggested clarifying the measurement objective

3.35 In recent meetings with stakeholders, some participants have suggested that as part of any project to clarify aspects of the IAS 37 measurement requirements, the Board should consider clarifying the overall measurement objective. They suggested that, without a clearer measurement objective to refer to, the Board might have difficulty reaching decisions on more detailed aspects of the measurement requirements, such as which costs an entity should include in the measure of a provision (see paragraphs 3.16–3.21) and whether the rate at which an entity discounts a provision should reflect the entity's own credit risk (see paragraphs 3.22–3.28).

The Board could align the measurement objective and requirements with the Conceptual Framework description of fulfilment value

3.36 The Board could clarify the measurement objective and requirements by aligning them with the description of fulfilment value in the *Conceptual Framework*.

3.37 In Appendix B to this paper, we have sketched the nature and extent of the amendments that might be required for full alignment. We have suggested that achieving full alignment might involve:

(a) redrafting the primary measurement objective in IAS 37—replacing the existing description (the best estimate of the expenditure required to settle the present obligation) with the description of fulfilment value in paragraph 6.17 of the *Conceptual Framework*;

(b) deleting the secondary measurement objective (the amount the entity would rationally pay to settle the obligation or transfer it to a third party), which is different from fulfilment value; and

(c) listing factors from paragraph 6.14 of the *Conceptual Framework* that paragraph 6.20 states should be reflected in fulfilment value, using each one as the introduction to an existing IAS 37 requirement.

3.38 The amendments look fairly extensive. However, the *Conceptual Framework* provides most of the wording and there is no significant restructuring—the existing measurement requirements in IAS 37 are grouped and ordered so they broadly correspond with factors the *Conceptual Framework* states are reflected in fulfilment value.

Aligning the measurement objective and requirements with the Conceptual Framework would have benefits

3.39 Aligning the IAS 37 measurement objective and requirements with the *Conceptual Framework* could have several benefits:

(a) the requirements would be clearer and would use terminology more consistent with that in other IFRS Standards, especially the more recent Standards;

(b) deleting the secondary measurement objective (paragraph 37 in IAS 37) would be the only substantive change. Deleting that paragraph would eliminate the main source of tension in the IAS 37 measurement requirements, that is the suggestion of a 'transfer' notion in the measurement objective.

(c) aligning the wording in IAS 37 with the *Conceptual Framework* description of fulfilment value might make it easier to site and draft additional requirements, for example on which costs an entity includes in the measure of a provision and whether the rate at which an entity discounts a provision should reflect the entity's own credit risk. The *Conceptual Framework* descriptions provide hooks on which to hang new requirements.

But aligning the measurement objective and requirements could raise new questions about the requirements and prolong the project

3.40 However, some people might question whether aligning the measurement objective and requirements with the *Conceptual Framework* would significantly affect the outcome of applying IAS 37 or make the requirements significantly easier to apply and enforce. Furthermore, the amendments required would be more extensive than those required to make more targeted improvements to the measurement requirements. Proposals to redraft some of the requirements (such as the requirement to make a risk adjustment) could raise questions about whether and how the redrafting changes the requirements. These questions could require additional consideration by the Board, prolonging any project and so delaying the issue of other amendments stakeholders view as important.

4 Onerous contracts

IAS 37 applies to a wide range of onerous contracts

4.1 IAS 37 applies to many types of onerous contract. Although other Standards specify requirements for most types of contract, those other Standards often omit requirements for recognising and measuring an additional amount if the contracts are onerous. Unless the other IFRS Standard has specific requirements, IAS 37 applies for the purpose of recognising and measuring that additional amount. Among the contracts to which IAS 37 applies for this purpose are:

(a) sales contracts within the scope of IFRS 15 *Revenue from Contracts with Customers*, including:

  (i) construction contracts previously within the scope of IAS 11 *Construction Contracts*, and

  (ii) contracts for the sale of assets within the scope of IAS 41 *Agriculture.*

(b) some executory contracts for the purchase of goods or services, including inventories, property, plant and equipment.

IAS 37 contains limited guidance on identifying and measuring onerous contracts

4.2 IAS 37 states that ‘if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision’. IAS 37 defines an onerous contract as ‘a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it’. It adds that the unavoidable costs ‘reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it’.[25]

[25] Paragraphs 66-68 of IAS 37.

Stakeholders have previously requested more guidance

4.3 In a previous project to amend IAS 37, the Board proposed to specify that:

(a) if the event that makes a contract onerous is an action of the entity, the liability does not arise until the entity has taken that action; and

(b) in identifying the least net cost of exiting from an operating lease of vacant property, an entity should take into account the sublease rentals it could reasonably obtain for the property, even if does not intend to enter into a sublease.[26]

4.4 Respondents generally supported these proposals. However, a few respondents—mainly auditors and preparers of financial statements—suggested the Board needed to clarify other aspects of the onerous contract requirements. Their suggestions reflected questions submitted to the IFRS Interpretations Committee in 2003, which the Committed referred to the Board for consideration in its project to amend IAS 37.[27]

4.5 Suggestions included clarifying:

(a) whether the 'cost of fulfilling' a contract includes only incremental costs of fulfilling that contract, or also an allocation of other costs of contract activities;

(b) whether the 'economic benefits expected to be received' should be interpreted narrowly (to include only the economic benefits to which the entity becomes directly entitled under the contract) or more broadly (to include other expected indirect benefits, such as access to future profitable contracts);

(c) what amount to include in the assessment if a contract will be fulfilled using assets already held by the entity and carried at an amount other than cost (such as agricultural produce and biological assets, which are carried at fair value less costs to sell);

(d) whether, and if so when, an entity should combine or segment contracts; and

---

26 Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, June 2005, paragraphs 55-58.

27 IFRIC *Update*, December 2003, Onerous contracts—operating leases and other executory contracts.

(e) that a contact to purchase an asset is not onerous solely because the contracted price has become unfavourable relative to current market prices. It is onerous only if the benefits that will be received from using the asset are expected to be lower than the price payable for the asset.

Circumstances have changed since stakeholders first made these requests

4.6 Circumstances have changed since we first collated the list of requests for clarification:

(a) the Board has recently approved a narrow-scope amendment to IAS 37. As described in more detail in paragraph 3.19, this narrow-scope amendment will clarify that, for the purpose of assessing whether a contract is onerous, the cost of fulfilling the contract comprises both the incremental costs of fulfilling that contract and an allocation of other costs that relate directly to fulling that contract and others.

(b) other problems reported by stakeholders often related to leases classified as operating leases applying IAS 17 *Leases* and so were not recognised in the statement of financial position. These problems have diminished in frequency and magnitude since IFRS 16 *Leases* replaced IAS 17 and, for most leases, requires entities to recognise lease assets and liabilities in the statement of financial position. An entity will appropriately recognise an onerous lease contract by applying the measurement requirements of IFRS 16 to the assets and liabilities recognised.

Some stakeholders still want some matters to be clarified

4.7 Feedback received at recent meetings with stakeholders, and during the development of the narrow-scope amendment, suggest that some of the matters identified in paragraph 4.5 still give rise to challenges in practice. Some preparers of financial statements in particular have continued to request that the Board clarifies

(a) whether the ‘economic benefits expected to be received’ under a contract should be interpreted narrowly or more broadly; and

(b) whether, and if so when, an entity should combine or segment contracts for the purpose of assessing whether contracts or components of contracts are onerous.

But others suggest questions are best addressed on a case-by-case basis

4.8 However, other stakeholders—in particular auditors—have suggested that answering these questions often requires consideration of an entity’s circumstances and the terms of its contracts and so are best addressed by applying judgement on a case-by-case basis. Any requirements developed to address these questions would need to consider all factors that might affect a decision. Such requirements could take time to develop and, if all they do is identify the factors to consider, might have little impact in practice.

5 Contingent assets and reimbursement rights

5.1 IAS 37 addresses two types of asset:

(a) *contingent assets*—possible assets whose existence will be confirmed only by the occurrence or non-occurrence of uncertain future events not wholly within the control of the entity. An example is the possible asset of a plaintiff in a lawsuit—the plaintiff's possible right to receive compensation. The existence or non-existence of such a right will be confirmed by a future court ruling or settlement.

(b) *reimbursement assets*—amounts that the entity expects to be reimbursed by another party if the entity settles an obligation that is within the scope of IAS 37.

Contingent assets

Users of financial statements support the existing recognition threshold

5.2 IAS 37 prohibits recognition of contingent assets, except when the realisation of income is virtually certain.[28] Thus the threshold for recognising contingent assets is higher than the 'probable outflows' threshold for recognising contingent liabilities.

5.3 The asymmetry between the thresholds is viewed by many stakeholders as a strength of IAS 37. Users of financial statements often report that, to be useful, amounts recognised as assets need to have a high degree of certainty.

Court settlements are adjusting events for contingent liabilities but not for contingent assets

5.4 However, some people have questioned requirements in IAS 37 relating to the timing of recognition of contingent assets. IAS 37 states that:

[28] IAS 37, paragraph 33.

> Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.[29]

5.5 The result of this requirement is that plaintiffs and defendants account differently for court settlements that occur between the end of a reporting period and the date on which the financial statements are authorised for issue:

(a) defendants treat court settlements as adjusting events. IAS 10 *Events after the Reporting Period* requires entities to adjust financial statements for events that provide evidence of conditions that existed at the end of the reporting period. IAS 10 gives examples of adjusting events. One example is the settlement of a court case that confirms that an obligation existed at the end of the reporting period.[30] The example is consistent with, and cross refers to, IAS 37 guidance on identifying liabilities.[31]

(b) plaintiffs treat court settlements as non-adjusting events. Although IAS 10 addresses the impact of a court ruling for a defendant in a lawsuit, it does not address the impact for the plaintiff, the party with a contingent asset. Accordingly, plaintiffs apply the requirement in IAS 37 for an asset and the related income to recognised in the financial statements of the period in which the change occurs. A change in assessment often arises when there is a court ruling or an out-of-court settlement.

5.6 The asymmetry can be attributed to the different nature of the recognition thresholds for the defendant and plaintiff. For the defendant, the focus for recognition is on existence, which depends on past events (whether it is more likely than not that the entity committed the act of wrongdoing for which damages are being claimed). The court settlement provides additional evidence of that past event, which is clearly evidence of a condition

---

29 IAS 37, paragraph 35.

30 IAS 10, paragraph 9(a).

31 IAS 37, paragraph 16.

that existed at the end of the reporting period. In contrast, for the plaintiff, the focus is outcome, ie future events (whether it is virtually certain that it there will be an inflow of economic benefits). The court settlement provides additional evidence of the probability of a future event, which is not, or not so obviously, evidence of a condition that existed at the end of the reporting period.

5.7 Occasionally preparers of financial statements have questioned us about the requirements for contingent assets. Although the requirement for a plaintiff to treat a court settlement as a non-adjusting event is relatively clear, and can be explained, it seems counter-intuitive to them.

But feedback suggests most stakeholders do not regard this matter as important

5.8 When we have presented this information to groups of stakeholders, they have suggested that they do not regard this matter as important. Although the acknowledge the inconsistency in IAS 37, they say it is not one that gives rise to major problems in practice. If an entity is the plaintiff in a court case, and the case is settled after the reporting period but before the financial statements are authorised for issue, disclosure of that fact and the amount of the settlement provides users of financial statements with all the information they need.

Reimbursement rights

Reimbursements are recognised if it is virtually certain that they will be received if the entity settles the obligation

5.9 IAS 37 states:

> 53 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that the reimbursement will be received if the entity settles the obligation.

5.10 The provision and reimbursement might relate to a specific loss event that has already occurred before the reporting date and for which the entity has insurance cover. For example, an entity might be defending itself against a claim for damages resulting from an accident. If the insurer has confirmed that it will cover the claim, the entity may be able to establish relatively easily that reimbursement is virtually certain if it settles the obligation.

5.11 However, we have been told that in other cases an entity may find it difficult to establish that reimbursement is virtually certain if it settles an obligation—even if the probability of reimbursement is very high and subject to relatively little measurement uncertainty. For example, establishing virtual certainty might be more difficult if the provision is for a future loss event. For example, a car manufacturer might give warranties on cars that it has sold, and recognise a provision, based on experience, for its best estimate of future warranty costs. It might also have contractual rights to claim reimbursement for specified costs from its component suppliers and, based on experience, be able make a reasonable estimate of the proportion of its future costs for which it is likely to be reimbursed. However, because the future claims have not yet occurred and so cannot be individually assessed, the manufacturer might find it more difficult to establish that reimbursement is virtually certain.

Some preparers have suggested that the recognition criterion is too restrictive

5.12 A few preparers of financial statements have told us that, in such cases, they find it difficult to recognise reimbursement assets, even though future inflows are both probable and subject to relatively little measurement uncertainty. The preparers have suggested that, if they do not recognise an asset in these situations, their financial statements do not report a faithful representation of their financial position.

5.13 An insurer also told us that the difficulty of recognising reimbursement rights is also distorting behaviour. It said that some manufacturers are being discouraged from insuring high-risk long-term warranty obligations by the need to recognise the premiums as an expense of the period (instead of as an asset that would compensate for the long-term warranty provision).

Stakeholders supported previous proposals for less restrictive criteria

5.14 As part of a previous project to amend IAS 37, the Board proposed to change the recognition threshold for reimbursements. The proposals would have required an entity have a *right* to reimbursement, not for the *inflows* to be virtually certain. Any uncertainty about the outcome would be reflected by taking that uncertainty into account in the measurement of the asset. [32]

5.15 Most respondents who commented on this matter agreed that with those proposals (some suggesting there should be a requirement for the future inflows to be probable).

But recent feedback suggests stakeholders do not regard this matter as important

5.16 We recently asked stakeholders for their views on this matter. We asked stakeholders who are likely to have had the broadest experience in practice—provisions specialists at large accounting firms and national standard setters. Some of these stakeholders agreed that IAS 37 requirements for reimbursement rights are not perfect. But even they said they think the existing requirements work reasonably well in practice and do not think revising the requirements should be a priority for the Board.

---

32 Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, June 2005, paragraph 46.

6 Other matters

Scope of IAS 37

IAS 37 applies only to liabilities of uncertain timing or amount

6.1 IAS 37 applies to liabilities of 'uncertain timing or amount' except:

(a) those resulting from executory contracts, except where the contract is onerous; and

(b) those covered by another IFRS Standard.

The Board previously proposed to widen the scope

6.2 In a previous project to amend IAS 37, the Board proposed to widen the scope of IAS 37 to include all non-financial liabilities (keeping the exceptions in paragraph 6.1). This would mean adding to the scope of IAS 37 non-financial liabilities whose amount and timing are certain.

6.3 The Board proposed this change on the grounds that:

(a) there is no reason to distinguish a provision from any other liability; and

(b) the recognition and measurement requirements proposed for IAS 37 would be appropriate for any non-financial liabilities not within the scope of another Standard.[33]

Stakeholders' views were mixed[34]

6.4 Many respondents agreed with the proposal to make IAS 37 a 'default' or 'catch all' Standard for non-financial liabilities. At present, entities need to apply the requirements of IAS 8 *Accounting Policies, Changes in Estimates and Errors* if no IFRS Standard

---

33 Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, June 2005, Paragraphs BC74-BC76 of the Basis for Conclusions.

34 IASB meeting, February 2006, Appendix to Agenda Paper 8—*Comment Letter Summary*, paragraphs 22-24.

specifically applies to a transaction. They need to apply judgement to develop a policy that results in relevant and reliable information, referring to and considering the applicability of IFRS requirements for similar transactions.[35] Such judgements can be difficult and would be avoided if IAS 37 became the applicable Standard.

6.5 However, some respondents disagreed with the proposal to widen the scope of IAS 37 because IAS 37, which has been developed specifically to address uncertainty, might not be the most appropriate Standard for liabilities that are not subject to any uncertainty.

6.6 Some respondents suggested that, before changing the scope of IAS 37, the Board should identify liabilities that would be brought within the scope, and consider whether IAS 37 would be an appropriate standard for those liabilities.

Widening the scope may have no practical benefits and could have unintended consequences

6.7 We have identified only a few examples of (probably uncommon) liabilities that might be brought within the scope of IAS 37 if were widened as previously proposed by the Board. We think an example is a statutory obligation to pay a fixed amount, such as a levy, at a fixed time (which would be a non-financial liability because it is not contractual).

6.8 We have not identified any benefits of bringing such liabilities within the scope of IAS 37—we have not identified any requirements in IAS 37 that make it particularly suitable for these liabilities.

6.9 We cannot know all the possible consequences of widening the scope—there could be unintended consequences.

[35] Paragraphs 10-11 of IAS 8.

Terminology

The terms provision, contingent liability and contingent asset are open to misinterpretation

6.10 Some people have observed that the term provision is outdated and open to misinterpretation. It dates back to a time before the statement of financial position included only items meeting the definition of an asset or a liability, and the term was sometimes used to describe amounts that did not meet the definition of a liability. Furthermore, in some jurisdictions, the term provision has been used to refer to asset valuation adjustments, such as impairment losses, or to items in the statement(s) of financial performance.

6.11 The term contingent liability is also open to misinterpretation. It provides a convenient shorthand term for any liability or possible liability that fails to satisfy the recognition criteria in IAS 37. However:

(a) common language does not limit the use of the term contingent liability in this way. In common language, a contingent liability exists when it is uncertain whether an outflow will occur, for example, if an entity incurs an obligation to pay ‘contingent consideration’ for an acquired business. Such liabilities may qualify for recognition. Thus, stakeholders sometimes misunderstand statements that IAS 37 does not permit the recognition of ‘contingent liabilities’.

(b) in IAS 37, the term contingent liability encompasses three different sets of items that do not form a single natural class:

(i) items for which it is uncertain whether an obligation exists;

(ii) items for which an obligation exists but for which it is not probable that a future outflow will occur; and

(iii) items that cannot be measured reliably.

6.12 Similarly, in common language, a 'contingent asset' is an asset whose outcome depends on future events. In IAS 37, the term is used differently, to refer to a possible asset whose existence is uncertain.

6.13 The Board has consciously avoided using the terms provision, contingent liability or contingent asset in the *Conceptual Framework*.

It might be relatively easy to remove the terms from IAS 37

6.14 Where IAS 37 at present refers to provisions, it could instead refer to liabilities. Where it refers to contingent assets or liabilities, it could refer to possible assets, possible liabilities and unrecognised liabilities.

6.15 Some entities use the term provision as a subheading within their financial statements to describe a range of recognised liabilities including for example, liabilities within the scope of IAS 37, deferred tax liabilities and some pension liabilities. They could continue this practice even if the term were removed from IAS 37.

But feedback suggests there is no significant demand from stakeholders

6.16 In a previous project to amend IAS 37, the Board proposed to remove all three terms (provision, contingent liability and contingent asset) from IAS 37. The feedback was mixed.

6.17 Changes in terminology are disruptive for people who read and apply IFRS Standards. Stakeholders we have consulted recently have not expressed any desire for updated terminology in IAS 37.

Appendix A—Feedback from stakeholders

A1 The research summary contains many references to feedback from stakeholders. The Board obtained most of this feedback from the meetings and documents described below.

June 2015—Joint meeting of the Global Preparers Forum (GPF) and Capital Markets Advisory Committee (CMAC)

A2 Participants discussed recognition criteria for provisions and whether single obligations should be measured at their most likely outcome or the expected value (probability-weighted average) of the possible outcomes: Agenda Paper 3A *Provisions and contingent liabilities (IAS 37)—Session overview and background information* and Agenda Paper 3B *Provisions and contingent liabilities (IAS 37)—Case studies*. The summary for that meeting reports the views expressed.

July 2015—Accounting Standards Advisory Forum (ASAF) meeting

A3 Participants discussed the evidence gathered by then of deficiencies in IAS 37, and the implications of the proposed changes to the *Conceptual Framework*:

(a) Agenda Paper 4 *Research—Provisions, Contingent Liabilities and Contingent Assets (IAS 37)*

(b) Agenda Paper 4A *Research—Provisions, Contingent Liabilities and Contingent Assets (IAS 37)—Project overview*

(c) Agenda Paper 4B *Research—Provisions, Contingent Liabilities and Contingent Assets (IAS 37)—Possible problems with IAS 37*

(d) Agenda Paper 4C *Research—Provisions, Contingent liabilities and Contingent Assets (IAS 37)—Implications of Conceptual Framework proposals*

A4 The summary for that meeting record ASAF members' views at that time on whether the IASB should take on a project to amend IAS 37 and what the scope of that project should be.

2015—Agenda consultation Request for Views

A5 In August 2015, the Board published for comment the Request for Views: *2015 Agenda Consultation*. The Board asked for views on, among other things, the relative importance and urgency of projects on the Board's research programme. Agenda Paper 22 *Research project—IAS 37 Provisions, Contingent Liabilities and Contingent Assets—Agenda Consultation Feedback* for the Board's April 2016 meeting summarises feedback on the importance and urgency of amendments to IAS 37.

September 2016—World Standard Setters meeting

A6 Meeting participants discussed the outcome of applying the *Conceptual Framework* asset and liability definitions to a range of illustrative examples, including several examples taken from IFRIC 21 *Levies* and IAS 37. The staff used the comments made at this meeting to help reach conclusions on the possible implications of the *Conceptual Framework* for those illustrative examples.

A7 The staff conclusions are set out in Agenda Paper 10C *Conceptual Framework—Testing the proposed asset and liability definitions—Illustrative examples*, discussed by the Board at its October 2016 meeting.

A8 The illustrative examples in that paper taken from IFRIC 21 and IAS 37 were:

Example number(s)	Topic	Corresponding example in Section C of IAS 37:
2.1	Product warranties	1
2.2	Contaminated land constructive obligation	2B
2.3	A court case	10
2.6 (a) and (b)	Restructuring costs	-
2.7	Legal requirement to fit smoke filters	6
2.8	Refurbishment costs	11B

Example numbers	Topic	Corresponding examples in IFRIC 21
2.5 (a), (b) and (c)	Levies	2, 3 and 4

March and April 2019—Meetings with ASAF, CMAC, GPF and accounting firms

A9 After the Board issued the *Conceptual Framework* in March 2018, the staff updated the research findings and formed tentative recommendations on whether the Board should take on a standard setting project, and which aspects of IAS 37 should be within the scope of that project. The Board discussed these tentative recommendations with participants at meetings of the ASAF, CMAC and GPF. The staff also sought informal views from provisions specialists at IFRS desks of large accounting firms.

A10 IASB May 2019 meeting Agenda Paper 22 *Provisions—Education session—scope of possible project to amend IAS 37* summarises the feedback from all those discussions.

Appendix B—Amendments required to align IAS 37 measurement requirements with *Conceptual Framework* description of fulfilment value

B1 This rough sketch illustrates the nature and extent of the amendments that might be required to fully align the IAS 37 measurement objective and requirements with concepts and terminology used to describe fulfilment value in the *Conceptual Framework*. The Board could modify some of the terminology to make it more specific to provisions and possibly simpler—we have not sought to do so for this illustration.

Measurement

~~Best estimate~~

~~**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.**~~

36 An entity shall measure a provision at the present value of the cash or other economic resources it expects to transfer to fulfil its present obligation. The measure shall reflect:

(a) current estimates of the future outflows (paragraphs 37–38A);

(b) possible variations in those outflows, caused by their inherent uncertainty (paragraphs 38B–40);

(b) the price for bearing that uncertainty (a risk adjustment); (paragraphs 42–44); and

(c) current assessments of the time value of money (paragraphs 45–47).

Amended paragraph 36

Replaces existing primary measurement objective with one more clearly aligned with *Conceptual Framework* description of fulfilment value:

- uses description of fulfilment value in *Conceptual Framework* paragraph 6.17 (*CF* 6.17).
- lists factors that *CF* 6.20 and *CF* 6.14 state are reflected in fulfilment value, using descriptions and terminology in *CF*

~~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. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the end of the reporting period. However, the estimate of the amount~~

Deleted paragraph 37

Deletes secondary description of measurement objective, which:

- is not consistent with *CF* description of fulfilment value.
- could be interpreted to require inclusion of a service margin.

~~that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.~~

Estimates of future outflows

37 **The estimates of the future outflows shall reflect current estimates of:**

(a) the amount of cash the entity will pay to fulfil its present obligation;

(b) the cost or carrying amount of other economic resources (such as goods or services) the entity will deliver to fulfil its present obligation; and

(c) the timing of the payments of cash or delivery of other economic resources.

37A The estimates of the future outflows reflect the carrying amount, rather than cost, of an economic resource if the entity already holds that resource and recognises it in its statement of financial position at a carrying amount different from cost.

37B [The economic resources an entity will deliver to fulfil its present obligation might be goods it will manufacture or services it will provide. The cost of such resources comprises the incremental costs of manufacturing and delivering the goods or providing the services, and a systematic allocation of other costs that relate directly to manufacturing or service activities.]

38 The estimates ~~of outcome and financial effect~~ are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting period.

New paragraphs 37 and 37A

Elaborate on bullet 36(a).

Introduce the notion of 'cost' for goods and services and so provide a context for paragraph 37B.

Refer to carrying amount to avoid measurement mismatches when the entity already holds a resource and measures it at either fair value (eg biological goods) or an amount that reflects an impairment (eg inventory at NRV).

New paragraph 37B

Specifies which costs to include.

Could be included if the Board decides to specify the same costs for measuring provisions as for recognising onerous contracts. See paragraphs 3.16–3.21 of this paper.

Possible variations in future outflows

38B The measure of a provision shall reflect possible variations in:

(a) the amount of cash the entity will pay to fulfil its present obligation;

(b) the cost of other economic resources the entity will deliver to fulfil its present obligation; and

(c) the timing of the payments of cash or delivery of other economic resources.

New paragraph 38B

Elaborates on bullet 36(b) referring to both amount and timing to be consistent with *CF* 6.14(b).

(We may be able to avoid repeating in paragraph 38B the factors listed in paragraph 37.)

38C [The measure of a provision [shall]/ [shall not] reflect the possibility that the entity may fail to fulfil its present obligation (its own credit risk).]

New paragraph 38C

Could be included if the Board decides to require or prohibit inclusion of entity's own credit risk. See paragraphs 3.22–3.28 of this paper.

Follows *CF* 6.15:

- description of own credit risk and
- portrayal of own credit risk as a factor that would be considered when assessing variations in outflows.

39 Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. 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'. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

Example

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of 1 million would result. If major defects were detected in all products sold, repair costs of 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75 per cent of the goods sold will have no defects, 20 per cent of the goods sold will have minor defects and 5 per cent of the goods sold will have major defects. In accordance with paragraph 24, an entity assesses the probability of an outflow for the warranty obligations as a whole.

The expected value of the cost of repairs is:

(75% of nil) + (20% of 1m) + (5% of 4m) = 400,000

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. For example, if an entity has to rectify a serious fault in a major plant that it has constructed 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.

41 The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under IAS 12.

Risk~~s and uncertainties~~ adjustment

42 The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in ~~reaching the best estimate of~~measuring a provision.

43 ~~Risk describes variability of outcome.~~ A risk adjustment may increase the amount at which a liability is measured. It may be included by increasing the estimates of the future outflows identified applying paragraph 37, by reducing the discount rate or rates selected applying paragraph 47, or by adding an explicit adjustment to the amount calculated as the present value of the future outflows.

Addition to paragraph 43

Replaces text currently in paragraph 47.

43A Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

44 Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 85(b).

Present value

45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the <u>cash or other economic resources the entity expects to transfer to fulfil its present obligation</u>~~expenditures expected to be required to settle the obligation~~.

Amended paragraph 45

Elaborates on requirement in bullet 36(d)

Carries through changes from paragraph 36.

46 Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money ~~and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted~~.

Deletion from paragraph 47

This message is covered by addition to paragraph 43, which explains more fully how risk could be reflected in the cash flows or discount rate (but not both).

Future events

48–50 [Unamended.]

Expected disposal of assets

51–52 [Unamended.]