

STAFF PAPER

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Project	Research—provisions, contingent liabilities and contingent assets (IAS 37)	
Paper topic	Possible problems with IAS 37	
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Summary

The International Accounting Standards Committee issued IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in 1998 and the IASB adopted it as part of the initial suite of Standards that formed IFRS. When it was issued, IAS 37 filled a significant void. Before then, entities could, for example, make provisions for future costs that were not present obligations, and this freedom provided significant scope for earnings manipulation. IAS 37 now restricts provisions to items meeting the definition of a liability. The Standard is widely credited with having substantially improved financial reporting as a result. Furthermore, preparers and auditors of financial statements often report that, in general, they do not encounter major problems applying IAS 37.

However, IAS 37 has imperfections and people have expressed concerns about some aspects of the Standard. This paper explains a range of concerns that have been raised with the IASB in recent years.

This paper is a work in progress. As we investigate some of these matters further, we may change our analysis of some of the problems and identify other, possibly better solutions. We will be grateful for all thoughts and ideas to help us develop the paper further.

TABLE OF CONTENTS

		Page
1	Identifying liabilities	4
	IAS 37 is contradictory and inconsistent with other Standards.....	4
	The IASB is identifying solutions in its Conceptual Framework project.....	5
2	Recognition criteria—provisions	6
	Should IAS 37 have a ‘probable outflows’ recognition criterion?	6
	IAS 37 has three recognition criteria for provisions	6
	The ‘probable outflows’ criterion has been the subject of much debate.....	6
	Proposed new concepts could support the existing criteria.....	6
	We are asking users and preparers if they experience any problems in practice	7
	Should thresholds for recognising litigation liabilities be higher?	8
	IAS 37 recognition thresholds are viewed as a challenge to US adoption of IFRS.....	8
	We are not planning to investigate this matter further at present.....	9
3	Measurement	10
	IAS 37 requires estimates of future cash flows, risk adjustments and discounting .	10
	Estimating uncertain future cash flows	10
	Existing IAS 37 requirements for single obligations are unclear	10
	There is evidence of diversity in practice	11
	The IASB could specify more precise requirements.....	12
	We are asking users and preparers for their views	12
	Identifying the costs to include in a provision	13
	IAS 37 is silent and practices diverge.....	13
	The IASB has done little work on these matters in the past.....	14
	Further analysis and consultation would be needed	15
	Risk adjustments	15
	Existing IAS 37 requirements are unclear	15
	IAS 37 could be amended to clarify the purpose of the risk adjustment	16
	Or IAS 37 could require liabilities to be measured without a risk adjustment.....	16
	Non-performance risk	17
	IAS 37 does not specifically address non-performance risk.....	17
	There is evidence of diversity in practice.....	18
	The IASB could specify that entities should exclude non-performance risk.....	18

4	Onerous contracts	20
	IAS 37 applies to a wide range of onerous contracts	20
	IAS 37 contains limited guidance on identifying and measuring onerous contracts ...	20
	Stakeholders have previously requested more guidance.....	21
	Changes in other Standards might mean that needs for guidance have changed	22
5	Reimbursement rights and contingent assets	23
	Contingent assets.....	23
	Users of financial statements support the high recognition threshold	23
	Court settlements are adjusting events for contingent liabilities but not for contingent assets.....	23
	The IASB could seek views on aligning the treatment of court settlements.....	25
	Reimbursements.....	26
	Reimbursements are recognised if it is virtually certain that they will be received.....	26
	Some preparers have suggested that the recognition criterion is too restrictive.....	27
	We do not know how widespread the concerns are	27
	But stakeholders supported previous proposals for less restrictive criteria.....	27
6	Other matters—scope, terminology and liability definition.....	29
	Scope of IAS 37.....	29
	IAS 37 applies only to liabilities of uncertain timing or amount	29
	The IASB previously proposed to widen the scope	29
	Views were mixed	30
	We need more evidence of the practical implications	30
	Terminology.....	31
	The terms ‘provision’, ‘contingent liability’ and ‘contingent asset’ are open to misinterpretation	31
	It might be relatively easy to remove the terms from IAS 37	32
	But the IASB would need to weigh the benefits against the disruption	32
	Liability definition	33
	The definition in IAS 37 is different from the proposed definition	33
	The proposed definition could replace the existing definition.....	33

1 Identifying liabilities

IAS 37 is contradictory and inconsistent with other Standards

- 1.1 A liability is a ‘present obligation ... arising from past events’. IAS 37 gives guidance on identifying present obligations. However, aspects of the guidance seem contradictory:
- (a) on one hand, paragraph 19 of IAS 37 states that 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 Interpretations Committee applied the guidance in 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 (irrespective of whether those actions are realistic). However, the interpretations have not completely clarified IAS 37:
- (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 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 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 while the entity could still, in theory at least, avoid the payment through its future actions.

The IASB is identifying solutions in its Conceptual Framework project

- 1.3 The apparent inconsistencies in IAS 37 are symptomatic of a more general lack of clarity about the meaning of the term ‘present obligation’ in the definition of a liability. The IASB decided to address this problem as part of its Conceptual Framework project. The concepts proposed in the IASB’s Exposure Draft *Conceptual Framework for Financial Reporting*, if finalised, could be applied to address the problems in IAS 37. See Agenda Paper 14C *Implications of Conceptual Framework proposals*.

2 Recognition criteria—provisions

Should IAS 37 have a ‘probable outflows’ recognition criterion?

IAS 37 has three recognition criteria for provisions

- 2.1 IAS 37 specifies that liabilities within its scope should be recognised if three recognition criteria are all met:
- (a) if on the basis of all available evidence, it is more likely than not that a 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.¹

The ‘probable outflows’ criterion has been the subject of much debate

- 2.2 The recognition criteria in IAS 37 have been the subject of much debate in the past. As is explained in more detail in Agenda Paper 14C, the debate has focused on the ‘probable outflows’ criterion. In its previous project to amend IAS 37, the IASB proposed to remove that criterion from IAS 37 to make IAS 37 consistent with other Standards. However, many respondents opposed the IASB’s proposal, arguing that the criterion serves a useful purpose in IAS 37.

Proposed new concepts could support the existing criteria

- 2.3 The IASB is proposing new concepts for recognition in its *Conceptual Framework* Exposure Draft. These concepts, if finalised, could guide the IASB in any future review of the recognition criteria in IAS 37.

¹ IAS 37, paragraphs 14, 15 and 23.

- 2.4 The concepts proposed in the *Conceptual Framework* Exposure Draft indicate that consistency with other Standards would not in itself be a reason for removing the ‘probable outflows’ criterion from IAS 37. As explained further in Agenda Paper 14C:
- (a) the *Conceptual Framework* Exposure Draft proposes that recognition requirements may need to vary between Standards, and that recognition of some assets or liabilities provides information that is not sufficiently useful to justify the cost of providing it.
 - (b) liabilities within the scope of IAS 37 have a characteristic that distinguishes them from many other liabilities. They typically cannot be measured by reference to an observable transaction price. They tend not to be traded, so do not have an observable *current* market price. Furthermore, and perhaps more unusually, there is typically no exchange transaction that provides an observable *historical* transaction price for the liability. The absence of *any* observable transaction price could justify recognition criteria in IAS 37 that are different from those in other IFRSs. 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.

We are asking users and preparers if they experience any problems in practice

- 2.5 The *Conceptual Framework* Exposure Draft discusses the same factors as those underpinning the existing recognition criteria in IAS 37—existence uncertainty, a low probability of outflows and exceptionally high measurement uncertainty. However, as explained further in Agenda Paper 14C, the *Conceptual Framework* Exposure Draft does not necessarily imply thresholds as high as the ‘more likely than not’ thresholds in IAS 37.
- 2.6 Accordingly, in reaching a preliminary view on the IAS 37 recognition criteria, the IASB might wish to consider whether the existing thresholds are too high.

- 2.7 However, when the IASB develops new financial reporting requirements, the IASB's objective should be to address problems with the existing requirements.² Combining this objective with the recognition concepts proposed in the *Conceptual Framework* Exposure Draft suggests that the IASB would consider lowering the existing thresholds only if it has evidence that:
- (a) there are examples in practice of liabilities that do not satisfy existing IAS 37 recognition criteria but whose recognition would provide useful information to investors, lenders or other creditors; and
 - (b) the costs of measuring these liabilities would not exceed the benefits.
- 2.8 To help identify any such liabilities, the IASB will be consulting members of the Capital Markets Advisory Committee and Global Preparers Forum when those groups meet on 11-12 June 2015.

Should thresholds for recognising litigation liabilities be higher?

IAS 37 recognition thresholds are viewed as a challenge to US adoption of IFRS

- 2.9 In 2009, the US Financial Accounting Standards Board (FASB) identified IAS 37 as a Standard that it thought might be difficult to apply in the US, and hence would be a potential challenge to US adoption of IFRS.³

² *IASB and IFRS Interpretations Committee Due Process Handbook*, paragraph 4.6.

³ 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.

- 2.10 The FASB's concern stems 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.⁴ However, for entities defending lawsuits, 'probable' is interpreted applying US GAAP as a much 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* 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'.
- 2.11 Consequently, the threshold applied in IAS 37 for recognising litigation liabilities (more likely than not) is lower than the threshold applied in US GAAP (prospects of success are slight). Applying the lower threshold, entities recognise liabilities for cases that they are 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.

We are not planning to investigate this matter further at present

- 2.12 Many companies that already apply IFRS have operations in the US, and are required to defend litigation within the US legal system. However, the IASB has not received any reports that such companies are encountering practical problems any greater than those encountered by companies applying US GAAP. Accordingly, we are not planning to investigate this matter further at present.

⁴ FASB Accounting Standards Codification, Section 450-20-25 (the Recognition Section of the Loss Contingencies Subtopic of the Contingencies Topic).

3 Measurement

IAS 37 requires estimates of future cash flows, risk adjustments and discounting

- 3.1 IAS 37 requires entities to measure liabilities at ‘the best estimate of the expenditure required to settle the present obligation at the end of the reporting period’. It adds that this 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’.⁵
- 3.2 This amount is typically determined by estimating the future cash flows required to settle the liability and discounting them to their present value.

Estimating uncertain future cash flows

Existing IAS 37 requirements for single obligations are unclear

- 3.3 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’.

- 3.4 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. ...

⁵ IAS 37, paragraphs 36-37.

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

There is evidence of diversity in practice

3.6 Some people think that the measurement objective in IAS 37 implies expected value measurements even for a single obligation—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. 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.⁶
- (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.⁷
- (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.)⁸
- (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.⁹

⁶ PwC IFRS *Manual of Accounting*, 2015, paragraphs 21.90 and 21.91.

⁷ Deloitte *iGAAP* 2015, Volume A, Chapter A12, Section 4.2.2.

⁸ KPMG *Insights into IFRS*, 2014/15, paragraph 3.12.110.30.

⁹ EY *International GAAP*, 2105, Chapter 27, section 4.2.

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

The IASB could specify more precise requirements

- 3.8 If the IASB were to take on a project to amend IAS 37, it could include within that project more precise requirements for identifying the ‘best estimate’ of the future cash flows for a single obligation:
- (a) it could require entities 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).

We are asking users and preparers for their views

- 3.9 To reach a preliminary views on this matter, the IASB would need to consider:
- (a) whether specifying more precise requirements would improve comparability;
 - (b) if so, what the overall measurement objective should be, and which requirements would be most consistent with that objective.
 - (c) which requirements would produce the most useful information for investors, at a cost that does not exceed the benefits.
- 3.10 To help it reach preliminary views on comparability, usefulness and cost-benefit considerations, the IASB will be consulting members of the Capital Markets Advisory Committee and Global Preparers Forum when those groups meet on 11-12 June 2015.

Identifying the costs to include in a provision

IAS 37 is silent and practices diverge

- 3.11 Many existing and proposed Standards require entities to measure assets or liabilities by reference to the costs of purchasing or producing the asset or of fulfilling the liability. Most of those Standards specify the types of costs that should be included, for example whether the costs should be only those directly related to the purchase or production of the specific asset or fulfilment of the particular liability, or whether they should also include an allocation of other attributable or indirect costs (eg fixed and variable overheads). Several Standards also list examples of the types of costs that should or should not be included.¹⁰
- 3.12 In contrast, IAS 37 is completely silent on this matter, leaving scope for diversity in practice. It is unclear, for example, how entities should measure obligations to provide goods (such as inventories) or services (such as decommissioning or environmental rehabilitation work). Some people take the view that only incremental costs should be included in any provision.¹¹ However, if this were the case:
- (a) entities would measure onerous contract liabilities differently depending on whether they were applying IAS 37 or IAS 11 *Construction Contracts*. IAS 11 requires entities to include both costs that relate directly to the specific contract and costs that are attributable to contract activity in general and can be allocated to the contract.¹²
 - (b) entities would measure the ‘cost’ of production assets differently depending on the purpose of the measurement: for the purpose of measuring goods held in inventory they would include overheads (as required by IAS 2 *Inventories*), whereas for the purpose of measuring or onerous contract obligations for goods not yet produced, they would exclude overheads.

¹⁰ See for example: IFRS 15 *Revenue from Contracts with Customers*, paragraphs 95-98, IAS 2 *Inventories*, paragraphs 10-16, IAS 11 *Construction Contracts*, paragraphs 16-21, IAS 16 *Property, Plant and Equipment*, paragraphs 16-22, Exposure Draft *Insurance Contracts*, June 2013, paragraph B66.

¹¹ KPMG *Insights into IFRS*, 2014/15, paragraph 3.12.180.20 and 3.12.660.30-50.

3.13 The practical implications of the lack of guidance in IAS 37 might become more pronounced when construction companies start to apply IFRS 15 *Revenue from Contracts with Customers* instead of IAS 11 *Construction Contracts*. IFRS 15 contains no requirements for measuring onerous contract liabilities, with the result that in future entities will instead apply IAS 37.¹³

3.14 IAS 37 is also unclear about whether provisions should include costs payable to third parties, such as legal costs expected to be incurred in negotiating the settlement of a legal claim. As one of the large accounting firms observes, there is diversity in practice in this area:

21.191 It is common practice for entities not to provide for future legal costs to defend against claims as the lawyers have not yet performed their service. This is the case even when such claims result in a probable liability for which a provision has been recorded. However, in certain circumstances (and with appropriate disclosure), some entities do provide for such costs.

21.192 Where it is established that an outflow of economic benefits is probable, it might be appropriate to include an estimate of future direct and incremental legal costs within the provision. This would meet the IAS 37 measurement criteria, as ... legal costs would be included in the amount that an entity would have to pay to a third party in order to transfer the liability to the third party. ...¹⁴

The IASB has done little work on these matters in the past

3.15 The IASB has done little work in the past on the types of costs to include in a provision. The 2010 Exposure Draft *Measurement of Liabilities in IAS 37* proposed that an entity should measure a provision for services at the price a contractor would charge to provide the services. The IASB took the view that there was no need for more detailed guidance

¹³ IAS 37, paragraph 5(g). IFRS 15, Basis for Conclusions, paragraphs BC294-BC296.

¹⁴ PwC IFRS *Manual of Accounting*, 2015.

on the costs to include in estimating that price—the entity would include whatever costs and margins a contractor would take into account in pricing the service.¹⁵

- 3.16 Most respondents opposed the proposal to measure provisions for services at an estimate of the price a contractor would charge to provide the services. Most respondents thought that an entity should estimate its own future costs. Some of these respondents suggested that the IASB should specify the types of costs to include. Suggestions included specifying incremental costs only, directly attributable costs, direct and indirect costs, or allowing entities to select the most appropriate approach for the circumstances.¹⁶

Further analysis and consultation would be needed

- 3.17 Because the IASB has not previously explored this matter in depth, it might need to investigate a range of different approaches and consult on their implications before reaching any preliminary views.

Risk adjustments

Existing IAS 37 requirements are unclear

- 3.18 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. ...

¹⁵ Exposure Draft *Measurement of Liabilities in IAS 37*, January 2010, paragraph B8 and BC21.

¹⁶ IASB Agenda Paper 7 (Appendix A), *Liabilities—comment letter summary*, September 2010, paragraph 3.4.5.

3.19 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 be higher than those expected. Some stakeholders have noted that the lack of guidance in IAS 37 leaves significant scope for diversity in the amounts at which provisions are measured.¹⁷

IAS 37 could be amended to clarify the purpose of the risk adjustment

3.20 Other Standards that require risk adjustments, such as IAS 36 *Impairment of Assets* and IFRS 13 *Fair Value Measurement*, are clearer. They state that the purpose of the risk adjustment is to reflect the price for bearing the uncertainty inherent in the future cash flows.¹⁸ Even if uncertain cash flows are measured at their expected value, a risk adjustment should be applied if there is a risk that the cash flows might ultimately differ from those expected. In the context of the IAS 37 measurement objective, the purpose of the risk adjustment would be to measure the amount that the reporting entity would rationally pay to be relieved of that risk.

3.21 The IASB could add this clarification to IAS 37.

Or IAS 37 could require liabilities to be measured without a risk adjustment

3.22 Alternatively, in the light of previous feedback, the IASB might wish to consider amending IAS 37 to require liabilities within its scope to be measured *without* adding a risk adjustment.

¹⁷ The different interpretations are discussed in PwC's IFRS Manual of Accounting, 2015, paragraphs 21.91 and 21.91.1, and in EY's *International GAAP*, 2105, Chapter 27, section 4.2.

¹⁸ IAS 36, paragraph A1. IFRS 13, paragraph B13.

3.23 The IASB proposed to clarify the purpose of the risk adjustment in its 2010 Exposure Draft *Measurement of Liabilities in IAS 37*. Many respondents—including most of the user groups and auditors commenting—expressed concerns about the proposal, particularly because the Exposure Draft did not include further 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 better served by disclosure of the risks and the range of possible outcomes.¹⁹

Non-performance risk

IAS 37 does not specifically address non-performance risk

- 3.24 IAS 37 requires entities to discount estimate 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’.
- 3.25 IAS 37 does not give any specific guidance on whether the measurement should take into account the risk of non-performance by the entity (sometimes called the entity’s own credit risk). Non-performance risk can be reflected by discounting the liability at the entity’s own borrowing rate instead of a (lower) risk-free rate. Discounting at the entity’s borrowing rate can substantially reduce the measure of very long-term liabilities (such as decommissioning and environmental rehabilitation obligations).

¹⁹ IASB Agenda Paper 7 (Appendix A), *Liabilities—comment letter summary*, September 2010, Section 3.5.

There is evidence of diversity in practice

- 3.26 Evidence of diversity in practice was submitted to the IFRS Interpretations Committee in 2010, along with a request for guidance. The Committee decided that the request for would be best addressed as part of the Board’s project to replace IAS 37. In reporting its decision, the Committee also noted that the predominant practice at that time was to exclude non-performance risk, which was generally viewed in practice as a risk of the entity rather than a risk specific to the liability.²⁰
- 3.27 IASB staff research indicates that practices continue to diverge. The predominant practice still appears to be to *exclude* the effects of non-performance risk. However, there are still some companies—concentrated in particular jurisdictions and sectors—that *include* the effects of non-performance risk, discounting long-term liabilities using their own borrowing rates, instead of a risk-free rate, and reporting smaller liabilities as a result.

The IASB could specify that entities should exclude non-performance risk

- 3.28 The IASB could eliminate diversity by adding guidance to IAS 37 to specify whether measures should include or exclude the effects of non-performance risk.
- 3.29 As is discussed further in Agenda Paper 14C, the predominance of fulfilment as the method of settling liabilities within the scope of IAS 37 could lead the IASB to focus on ‘fulfilment value’ if it were to develop new measurement requirements for IAS 37.
- 3.30 The *Conceptual Framework* Exposure Draft proposes to define fulfilment value as ‘the present value of the cash flows that an entity expects to incur as it fulfils a liability’. To the extent that liabilities within the scope of IAS 37 are measured at fulfilment value, the IASB might reach a preliminary view that entities should exclude non-performance risk:

²⁰ IFRIC *Update*, March 2011, Agenda decisions.

- (a) the *Conceptual Framework* Exposure Draft proposes that, to provide the most useful information, it may sometimes be appropriate to exclude from fulfilment value the effect of the possibility of non-performance by the entity.²¹
- (b) in response to the 2010 Exposure Draft of revised proposals for amending the measurement requirements of IAS 37, some respondents asked the IASB to clarify whether non-performance risk should be included or excluded. All of those who expressed an opinion thought that non-performance risk should be excluded. And, in particular, they thought that there should be no requirement to *re-measure* liabilities to take into account changes in non-performance risk.

²¹ Exposure Draft *Conceptual Framework for Financial Reporting*, May 2015, paragraph 6.35.

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 any requirements for recognising and measuring an additional amount if the contracts are onerous. Unless the other 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, and
 - (ii) contracts for the sale of assets within the scope of IAS 41 *Agriculture*.
- (b) many enforceable 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’.

4.3 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 further clarifies that:

- (a) 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’; and
- (b) ‘before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract’.²²

²² IAS 37, paragraphs 66-69.

Stakeholders have previously requested more guidance

- 4.4 In its previous project to amend IAS 37, the IASB proposed adding further guidance 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 that it could reasonably obtain for the property, even if does not intend to enter into a sublease.²³
- 4.5 Respondents generally supported these proposals. However, a few respondents—mainly auditors and preparers of financial statements—suggested that there was also a need for guidance on other matters. Their suggestions reflected questions submitted to the IFRS Interpretations Committee in 2003 and referred by the Interpretations Committee on to the IASB for consideration in its project to amend IAS 37.²⁴
- 4.6 Suggestions included:
- (a) IAS 37 should specify that a contract to purchase an asset is not onerous purely 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.
 - (b) IAS 37 should specify whether the ‘economic benefits expected to be received’ should be interpreted narrowly (ie to include only the economic benefits to which the entity becomes directly entitled under the contract), or more broadly (ie to include other expected indirect benefits, such as access to future profitable contracts).
 - (c) IAS 37 should specify whether the ‘cost of fulfilling’ a contract includes only direct incremental costs, or also an allocation of indirect costs.
 - (d) specific guidance is needed for contracts that will be fulfilled using the entity’s existing assets, especially assets are being carried at an amount other than cost

²³ Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, June 2005, paragraphs 55-58.

²⁴ IFRIC *Update*, December 2003, Onerous contracts—operating leases and other executory contracts.

(such as agricultural produce and biological assets, which are carried at fair value less costs to sell).

- (e) IAS 37 should clarify whether an entity should ever divide a contract into components and apply the onerous contracts test to each component separately.

Changes in other Standards might mean that needs for guidance have changed

4.7 Circumstances have changed since the IASB received requests for additional guidance on onerous contracts. For example:

- (a) some of the requests were specific to onerous operating leases. Problems with onerous operating leases will diminish significantly if the proposed new leasing Standard requires lessees to recognise most lease assets and liabilities on the balance sheet.²⁵ A loss would be recognised as an impairment of the lease asset, not as an onerous contract liability.
- (b) conversely, as discussed in paragraph 3.13, some of the requested guidance might become more widely-applicable when IAS 37 replaces IAS 11 for identifying and measuring onerous construction contracts. Furthermore, it is possible that some other types of contract with a propensity to become onerous are now more prevalent as some markets (such as energy markets) have expanded.

4.8 We suspect that there is still significant diversity in practice. However, it is difficult to identify the extent of the diversity from published financial statements because, with some exceptions, entities tend not to disclose in detail their policies for identifying and measuring onerous contracts.

4.9 Accordingly, before considering the suggestions in paragraph 4.6 further, we intend to ask stakeholders for their current views. We think that the larger accounting firms and national standard setters might be particularly well-placed to advise on this matter, given their exposure to a wide range of transactions.

²⁵ [Project Update, *Leases: Practical implications of the new Leases Standard*, March 2015.](#)

5 Reimbursement rights and contingent assets

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 high recognition threshold

5.2 IAS 37 prohibits recognition of contingent assets, except when the realisation of income is virtually certain.²⁶ 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 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. They often express satisfaction that the recognition thresholds for uncertain assets are higher than those for uncertain liabilities.

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

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

²⁶ 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.²⁷

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 for that period 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.²⁸ The example is consistent with, and indeed cross refers to, IAS 37 guidance on identifying liabilities.²⁹
- (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, ie 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. The requirements of IAS 37 are interpreted mean that a plaintiff should recognise its right to compensation in the financial statements of the period in which a favourable ruling or settlement occurs: the ruling or settlement is a ‘non-adjusting’ event for the plaintiff, even though it is an adjusting event for the defendant.

²⁷ IAS 37, paragraph 35.

²⁸ IAS 10, paragraph 9(a).

²⁹ IAS 37, paragraph 16.

- 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 wrong-doing for which damages are being claimed). The court settlement provides additional evidence of that past event, which is clearly evidence of a condition 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 question 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.

The IASB could seek views on aligning the treatment of court settlements

- 5.8 In its previous project to amend IAS 37, the IASB proposed to remove contingent assets from the scope of IAS 37.³⁰ Accordingly, it did not consider any possible amendments to the existing requirements for contingent assets. Further research would be needed before the IASB reached any preliminary views on whether and how to align the treatment by defendants and plaintiffs of court settlements after the reporting period.

³⁰ In developing the 2005 Exposure Draft, the IASB had rejected the IAS 37 notion of existence uncertainty in the context of court cases: it had taken the view that a defendant in a court case always has a liability (an unconditional obligation to stand ready to act as the court directs) and a plaintiff always has an asset (an unconditional right to have its claim for damages considered by the courts). The IASB had concluded that such an asset would be a non-monetary asset without physical form, and hence would be within the scope of IAS 38 *Intangible Assets*. Accordingly, the 2005 Exposure Draft proposed to remove the requirements for contingent assets from IAS 37. Later, the IASB reversed its tentative conclusion that a court case always gives rise to a liability for the defendant and acknowledged that there may be existence uncertainty. But it halted the project to amend IAS 37 before specifically reconsidering contingent assets.

Reimbursements

Reimbursements are recognised if it is virtually certain that they will be received

5.9 IAS 37 states that:

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 (or been alleged to have 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 entity has made a provision for the claim, and if the insurer has confirmed that it will cover the claim if the entity loses the case, the entity may be able to establish relatively easily 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. 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, again 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. Such assets would be recognised if they were reinsurance rights within the scope of IFRS 4 *Insurance Contracts*.
- 5.13 An insurer has also told the IASB staff 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).

We do not know how widespread the concerns are

- 5.14 Concerns about recognition criteria for reimbursement rights have been expressed informally to the IASB staff by a few preparers of financial statements. However, we have not yet done further work to establish how widespread the concerns are. Further research would be required before the IASB reaches any views on whether, and if so how, to amend IAS 37.

But stakeholders supported previous proposals for less restrictive criteria

- 5.15 We do, however, already have some evidence that stakeholders might support amendments that make the recognition criteria for reimbursement rights less restrictive.
- 5.16 The IASB's 2005 Exposure Draft of proposed amendments to IAS 37 included a proposal to change the recognition threshold for reimbursements. The proposals focused on the existence of an asset (a right to reimbursement) and would have removed the requirement

for the future 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.³¹

- 5.17 Most respondents who commented on this matter agreed that the threshold should be changed—ie that the focus should be on the right to reimbursement, and that there should not be a requirement for the future inflows to be virtually certain. Some suggested that there should, however, be a requirement for the future inflows to be probable.

³¹ Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, June 2005, paragraph 46.

6 Other matters—scope, terminology and liability definition

Scope of IAS 37

IAS 37 applies only to liabilities of uncertain timing or amount

- 6.1 IAS 37 applies to a subset of liabilities called ‘provisions’. The existing *Conceptual Framework* describes provisions as ‘liabilities that can be measured only by using a substantial degree of estimation’.³² IAS 37 itself defines a provision as ‘a liability of uncertain timing or amount’.³³
- 6.2 IAS 37 applies to provisions except:
- (a) those resulting from executory contracts, except where the contract is onerous; and
 - (b) those covered by another Standard.

The IASB previously proposed to widen the scope

- 6.3 In its previous project to amend IAS 37, the IASB proposed to widen the scope of IAS 37 from ‘provisions’ to ‘non-financial liabilities’ (keeping the exceptions in paragraph 6.2). In essence, this would mean that liabilities would not have to be ‘of uncertain timing or amount’.
- 6.4 The IASB’s reasons for proposing this change were that:
- (a) there is no clear rationale for distinguishing a provision from any other liability; and
 - (b) the recognition and measurement requirements that the IASB was proposing for IAS 37 would be appropriate for any non-financial liabilities not within the scope of another Standard.³⁴

³² *Conceptual Framework*, paragraph 4.19.

³³ IAS 37, paragraph 10.

³⁴ Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, June 2005, paragraphs BC74-BC76.

Views were mixed³⁵

- 6.5 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 specifically applies to a particular transaction. They need to apply judgement to develop a policy that results in relevant and reliable information and must do so by referring to and considering the applicability of IFRS requirements for similar transactions.³⁶ Such judgements can be difficult and would be avoided if IAS 37 became the applicable Standard.
- 6.6 However, some respondents disagreed with the proposal to widen the scope of IAS 37 because they viewed the existing distinctions between certain liabilities and uncertain liabilities (ie provisions) as useful. And it could be argued that 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.
- 6.7 Some respondents suggested that the IASB should undertake further work to identify liabilities that would be brought within the scope of IAS 37 and to explain why IAS 37 would be the appropriate standard for those liabilities.

We need more evidence of the practical implications

- 6.8 We have not yet identified the range of liabilities that could be brought within the scope of IAS 37 if it were to be made a catch-all Standard, so have not yet evaluated the potential benefits. National standard setters and large accounting firms in particular might be able to help identify any specific benefits or unintended consequences.

³⁵ IASB meeting, February 2006, Appendix to Agenda Paper 8—Comment Letter Summary, paragraphs 22-24.

³⁶ IAS 8, paragraphs 10-11.

Terminology

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

- 6.9 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 income statement (rather than in the statement of financial position).
- 6.10 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 to items not qualifying for recognition. 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 often 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.
- 6.11 Similarly, in common language, a ‘contingent asset’ is an asset whose outcome depends on future events. In IAS 37, the term is used differently, ie to refer to a possible asset whose existence is uncertain.

- 6.12 The IASB has not used the terms provision, contingent liability or contingent asset in the *Conceptual Framework* Exposure Draft.

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

- 6.13 Where IAS 37 at present refers to recognition, measurement, presentation or disclosure of a ‘provision’, it could instead refer to a ‘liability’. Where it refers to ‘contingent liabilities’, or to ‘contingent assets’, it could refer to ‘possible liabilities’, ‘possible assets’ or ‘unrecognised liabilities’.
- 6.14 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 the IASB would need to weigh the benefits against the disruption

- 6.15 However, changes in terminology are disruptive for people who read and apply IFRS. We do not have a feel for whether those people would view the potential benefits of changing the terminology as outweighing the disruption.
- 6.16 The IASB proposed to remove all three terms (provision, contingent liability and contingent asset) as part of its previous project to amend IAS 37. However the responses it received were mixed, respondents formed their views in the context of the other changes being proposed at that time, and views on terminology are likely to have changed in the 10 intervening years.
- 6.17 Further consultation could help the IASB to reach preliminary views.

Liability definition

The definition in IAS 37 is different from the proposed definition

- 6.18 The defined terms in IAS 37 include the existing *Conceptual Framework* definition of a liability:

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.³⁷

- 6.19 The *Conceptual Framework* Exposure Draft proposes to amend the existing definition. It proposes that:

A liability is a present obligation of the entity to transfer an economic resource as a result of past events.³⁸

The proposed definition could replace the existing definition

- 6.20 If the proposed liability definition is finalised in the revised *Conceptual Framework*, the IASB could simply change the definition in IAS 37 to make it consistent. The staff have not identified any consequential difficulties: none of the requirements in IAS 37 depend on aspects of the definition that would change.

³⁷ IAS 37, paragraph 10

³⁸ Exposure Draft *Conceptual Framework for Financial Reporting*, May 2015, paragraph 4.4.