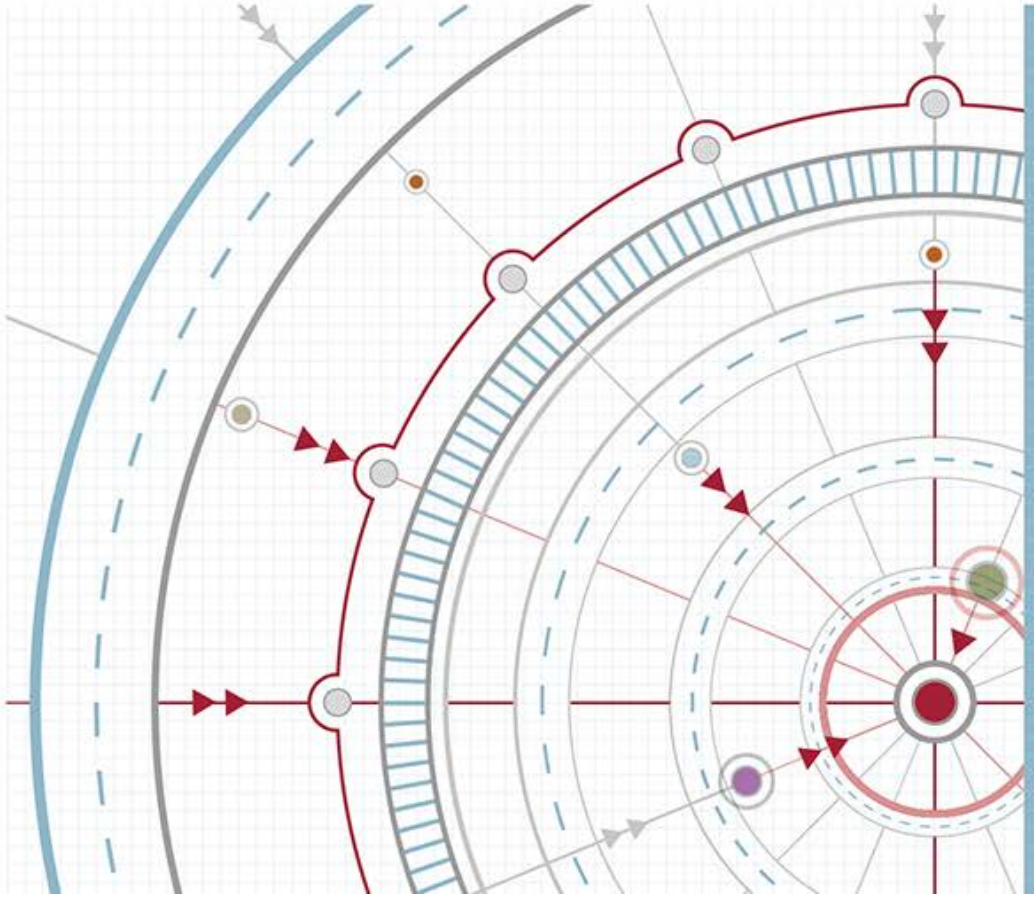
IFRS® Foundation

Agenda Paper 4



GPF meeting
March 2019

Provisions

Joan Brown-Technical Staff

Meeting objective

- To hear your views on the scope of a possible project to make targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Background

The Board will soon discuss:

- whether to undertake a project to make targeted improvements to IAS 37, and
- if so, which aspects of IAS 37 to consider improving.

Scope of possible project

The staff intend to recommend that the Board undertakes a project that focuses on:

1. aligning the IAS 37 liability definition and supporting guidance with the *Conceptual Framework*. Amendments could include replacing IFRIC 21 *Levies*.
2. clarifying which costs to include in the measure of a provision.
3. specifying whether the rate at which provisions are discounted should reflect own credit risk.

What won't be within the scope

The Board is not planning a fundamental review of IAS 37—stakeholders tell us that most aspects work well in practice.

Notably, the staff plan to recommend that the Board does **not** review the criteria for recognising liabilities, the overall measurement objective or the disclosure requirements. The reasons are explained on slides 16–19.

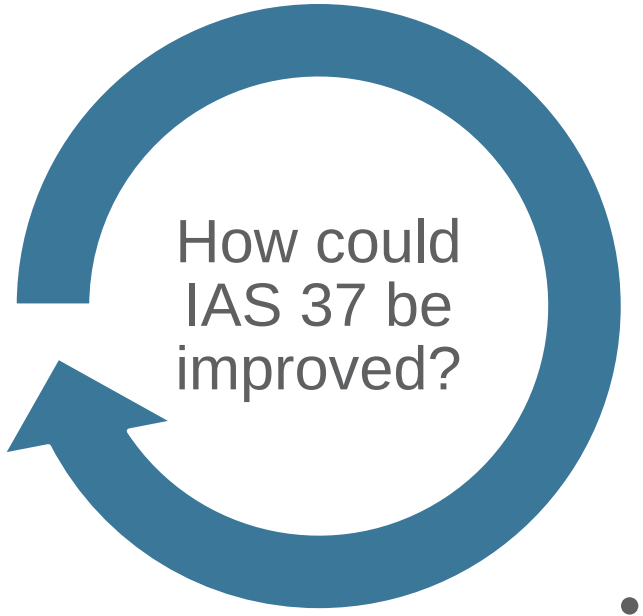
Questions for GPF members

- Do you agree that the Board should undertake a project to make targeted improvements to IAS 37 and that the project should focus on:
  1. Aligning the liability definition and supporting guidance with the *Conceptual Framework,* possibly replacing IFRIC 21 *Levies*? See slides 4–7
  2. Clarifying which costs to include in the measure of a provision? See slides 8–10
  3. Specifying whether the rate at which provisions are discounted should reflect the entity's own credit risk? See slides 11–13
- Do you think the Board should consider any other targeted improvements to IAS 37?

1 Aligning liability definition and guidance with *Conceptual Framework*

- IAS 37 is unclear—does an entity have a liability if:
  - it has an obligation that it will have to settle only if it takes a future action; but
  - it has no realistic ability to avoid that action?
- The Interpretations Committee issued IFRIC 21 *Levies*, which concluded that answer is ‘no’—the entity does not have a liability for a levy until it takes the action that triggers payment of the levy.
- IFRIC 21 has been criticised for not providing useful information. Some levies that accumulate over a period are not recognised until a point in time at or after end of period.

1 Aligning liability definition and guidance with *Conceptual Framework*



- New concepts in the revised *Conceptual Framework* could be added to IAS 37 to provide clearer guidance. New concepts state that a liability arises when:
  - an entity receives benefits or conducts an activity and, as a consequence, will or may have to transfer an economic resource; and
  - the entity has no practical ability to avoid the transfer.
- IFRIC 21 could be withdrawn and replaced with new application guidance in IAS 37 for levies and other obligations conditional on the entity's future actions.

1 Aligning liability definition and guidance with *Conceptual Framework*

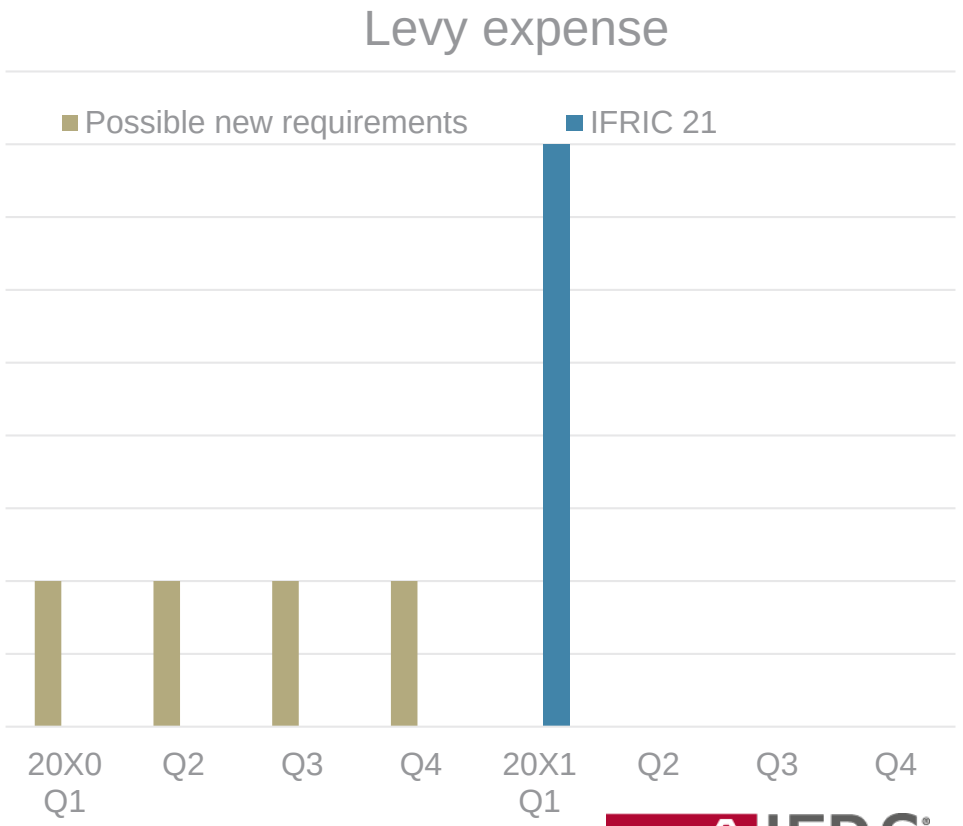
- Some levies (but not all) would be recognised progressively as they accumulate over a period instead of at a point in time at or after the end of the period.

See example on slide 7

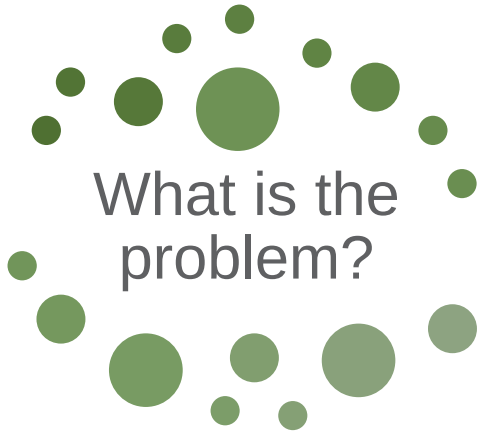
Example

Facts: A government charges a levy on companies operating in a specified market on 1 January 20X1. Each entity must pay 1% of the revenue it earned in that market in the previous calendar year (20X0).

Existing requirements—IFRIC 21	Possible new requirements
• Liability arises when entity takes action that triggers payment—ie operates in market on 1 January 20X1.	• Liability arises as entity generates revenue if entity has no practical ability to leave market before 1 January 20X1.
• Liability for levy recognised in full on 1 January 20X1.	• Liability for levy recognised progressively over 20X0.



2 Clarifying which costs to include in measure of provision



- The Board has proposed amendments to IAS 37 to clarify which costs to include in assessing *whether* a contract is onerous—see Agenda Paper 3.
- If those amendments are finalised, questions will arise:
  - Should the same costs be included in *measuring* onerous contract provisions?
  - If so, should the same types of costs be included in measuring *other* provisions for costs of providing goods or services?
- Current practice varies—some entities include only incremental costs, others also include other directly related costs.

2 Clarifying which costs to include in measure of provision

- The Board could specify requirements for measuring provisions consistent with those for assessing whether a contract is onerous.

  An entity would include both the incremental costs of settling the obligation and an allocation of directly related costs, such as depreciation of equipment used.

2 Clarifying which costs to include in measure of provision

- Entities could be affected if they have contracts to provide goods or services and at present include only the incremental costs in measuring onerous contract provisions. They might recognise larger provisions in future.

- Limited implications for other entities?

3 Specifying whether discount rate includes own credit risk

What is the problem?

- IAS 37 does not specify whether rates used to discount provisions should include the risk that entity may fail to fulfil its liability (own credit risk).
- Differences in practice lead to significant differences in measures of large long-term provisions, eg provisions for decommissioning long-life assets.
- Absence of requirements to disclose discount rates used can further impede comparability.

3 Specifying whether discount rate includes own credit risk

How could IAS 37 be improved?

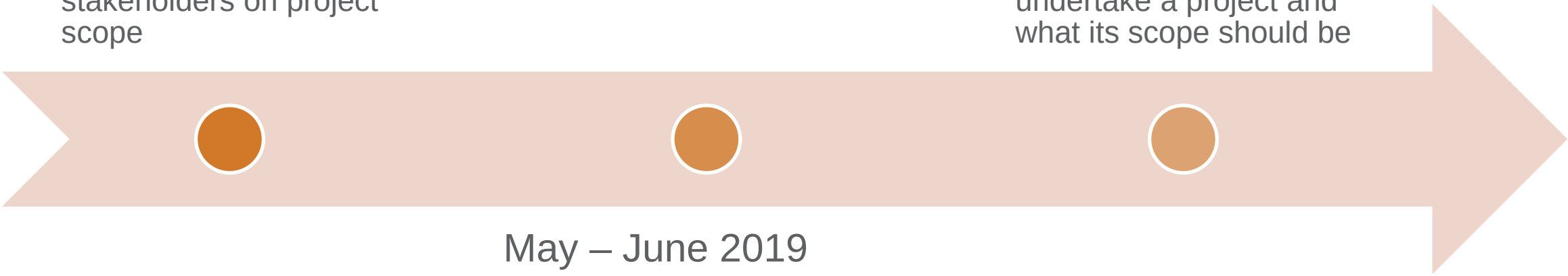
- The Board could specify in IAS 37 whether discount rates should include or exclude own credit risk—having asked for stakeholder views on which rate leads to more useful information.
- The Board could also consider adding to IAS 37 requirements for disclosure of information about discount rates used.

3 Specifying whether discount rate includes own credit risk

What would change in practice?

- There would be less diversity in practice and financial statements of different entities would be more comparable.
- If own credit risk is excluded (or included) some entities will recognise significantly larger (or smaller) provisions in future than they have done in the past.

Next steps



March – April 2019

- Staff gather feedback from stakeholders on project scope

May – June 2019

- Staff prepare summary of evidence gathered
- Including feedback from this meeting and meetings with other stakeholders

Later this year

- Board discusses summary and decides whether to undertake a project and what its scope should be

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Appendix

Aspects of IAS 37 not being considered for review at present

Recognition criteria

IAS 37 requirements

Paragraph 14 of IAS 37 requires a provision to be recorded (recognised) in financial statements if:

1. an entity has a present obligation as a result of a past event;
2. it is probable that an outflow of resources will be required to settle the obligation; and
3. a reliable estimate can be made of the amount of the obligation.

Reasons for not reviewing the recognition criteria

In a previous (never completed) project to amend IAS 37, the Board proposed to remove from IAS 37 the second of the three recognition criteria—the 'probable outflows' criterion.

However, many stakeholders opposed this proposal. Few of the users of financial statements consulted said they would find recognition of low-probability liabilities useful. And preparers of financial statements argued that the costs of recognising and measuring low-probability liabilities would be substantial, and outweigh any benefits. The Board took the project off its agenda without finalising its proposals.

Measurement objective—best estimate

IAS 37 requirements

Paragraph 36 of IAS 37 requires entities to measure provisions at the best estimate of the expenditure required.

Paragraph 37 states 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.

Paragraph 40 states that for a single obligation, the individual most likely outcome may be the best estimate of the liability, but an entity considers other possible outcomes.

Reasons for not reviewing the measurement objective

The measurement objective in IAS 37 is not precise and people interpret it in different ways. In a previous (never completed) project to amend IAS 37, the Board proposed to specify that:

1. the objective is to measure the amount the entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party; and
2. to satisfy that objective, an entity would measure a liability at the expected value (probability-weighted average) of the possible outcomes.

However, many respondents disagreed with this proposal arguing, among other things, that expected value is not always the most useful measure of a provision—especially if it is not one of the possible outcomes (as might be the case, for example, for litigation provisions).

The Board sought further input from its Global Preparers Forum and Capital Markets Advisory Committee when those two groups met jointly in June 2015. Members of both groups expressed a view that IAS 37 should continue to allow management to use judgement to arrive at the best estimate of the liability.

The Board took the project off its agenda without finalising its proposals.

Disclosure requirements

IAS 37 requirements

Paragraph 85 requires entities to disclose for each class of provision:

1. a description of the nature of the obligation and expected timing of any outflows; and
2. an indication of the uncertainties about the amount and timing of the outflows.

Paragraph 86 requires entities to disclose for each class of contingent liability (unless remote):

1. an estimate of its financial effect; and
2. an indication of the uncertainties about the amount or timing of any outflow.

Paragraph 92 permits entities not to disclose information in 'extremely rare' cases where disclosure would prejudice seriously the entity's position in a dispute.

Reasons for not reviewing the disclosure requirements

From time to time, some investors have told us that the information disclosed about provisions and contingent liabilities can be poor.

However, responses to the Board's last agenda consultation did not identify a need for either a fundamental review of the IAS 37 disclosure requirements or targeted amendments to address specific shortcomings in those requirements.

IAS 37 applies to many and diverse types of obligations—including decommissioning obligations, litigation liabilities, taxes other than income taxes and onerous contracts. So the disclosure requirements have to be general in nature, and the quality of information disclosed can depend on how well preparers of financial statement apply the general requirements to particular types of obligation. Inadequate disclosure could reflect a need for better application of existing requirements, rather than a need to enhance existing requirements.