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## **IASB Project *Provisions – Targeted Improvements*** **Project update**

### **Introduction and Objective**

- 1 The purpose of this session is to provide an update on the IASB project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

### **Scope of the active IASB project**

- 2 At the meeting in January 2020, the IASB discussed the findings from the research project. The details are provided in Agenda Paper 11-02.
- 3 The IASB Staff provided the findings and analysis of twelve potential issues. The following three aspects satisfied the criteria of the IFRS Foundation Due Process Handbook (the DPH). The IASB agreed with the analysis of the IASB Staff and decided to add a project to provide those three targeted amendments to IAS 37 to its working plan:
  - (a) align the liability definition and requirements for identifying liabilities in IAS 37 with the *Conceptual Framework for Financial Reporting*;
  - (b) clarify which costs to include in the measure of a provision; and
  - (c) specify whether the rate at which an entity discounts a provision should reflect the entity's own credit risk.
- 4 The following nine issues did not satisfy the criteria of the DPH and were not added to the project:

Issue	Reason for rejection
'Probable outflows' criterion prevents recognition of some liabilities.	Users of financial statements do not regard recognition of provisions for low probability outflows as useful. So probable outflows criterion is consistent with the Conceptual Framework.
Recognition thresholds are lower than those applied by entities applying US GAAP.	There are no reports that this difference causes additional problems in practice for entities with US operations that apply IFRS Standards.
IAS 37 does not specify whether the 'best estimate' of the expenditure required to settle a single obligation is the most likely outcome or the expected value of possible outcomes.	Stakeholders (including users of financial statements) think IAS 37 should continue to allow management to apply judgement to decide which measure provides the best estimate of the outcome.
Requirements for risk adjustments are unclear.	Stakeholders have not identified this matter as important.
Some stakeholders have requested for clarification of meaning of economic benefits and when to combine or segment contracts.	Other stakeholders think questions that arise in practice are best addressed by applying judgement on a case-by-case basis.

Settlement of a court case between the end of the reporting period and authorisation of the financial statements is treated as a 'non-adjusting' event for the entity with contingent asset.	Stakeholders acknowledge the asymmetry in the treatment of contingent assets and contingent liabilities, but do not regard it as important.
Recognition criteria are too restrictive.	Stakeholders do not regard this matter as important enough to justify amendment.
The scope is not quite wide enough for IAS 37 to be the default IFRS Standard for all liabilities not within the scope of another Standard.	Widening the scope may have no practical benefits and could have unintended consequences.
The terms provision, contingent liability and contingent asset are open to misinterpretation.	Changes in terminology are disruptive and there is no significant demand for change from stakeholders.

*EFRAG TEG/CFSS discussion in March 2019*

5 Refer to Appendix 3.

*April 2019 ASAF discussion*

6 In April 2019, the ASAF members discussed whether the IASB should undertake a project to make targeted improvements to IAS 37 and, eventually, the scope of such project. The following comments were provided:

*General Comments*

7 Most ASAF members expressed support for aligning the liability definition and supporting guidance in IAS 37 with the *Conceptual Framework*. Two members expressed particular support for amendments that would result in the IASB withdrawing IFRIC 21 *Levies*.

8 Three ASAF members cautioned that aligning IAS 37 with the *Conceptual Framework* was unlikely to be straightforward and should not be viewed as a narrow-scope project. In particular, applying the 'no practical ability to avoid' concept to the broad range of transactions covered by IAS 37 could require substantial thought.

9 One ASAF Member noted the Board had previously suggested that one outcome of its project on *Financial Instruments with Characteristics of Equity* could be further amendments to the liability definition in the *Conceptual Framework*. It was suggested that, if the IASB still regards this outcome as possible, it should not amend IAS 37 in the meantime.

*Clarifying which costs to include*

10 Five ASAF members expressed support for clarifying which costs to include in the measure of a provision. Two of them suggested that if the IASB clarifies which costs to include in the measure of a provision for onerous contracts, it should also clarify which economic benefits to include. Another two members suggested that deciding which economic benefits to include can be an issue for entities that enter into a loss-making contract (for example, to sell a vehicle) in the expectation that the contract will lead to future profitable contracts (for example, to maintain the vehicle).

*Clarifying whether discount rate should reflect own credit risk*

11 Six ASAF members expressed support for clarifying whether rates used to discount provisions should reflect the entity's own credit risk. However, four of them members suggested this issue should not be addressed in isolation and it should be considered as part of a broader review of the requirements for risk adjustments.

12 One ASAF member suggested requiring entities to disclose information about how they selected discount rates used. Such information could be particularly useful in jurisdictions without deep financial markets, where there may be greater diversity in practice.

*Other topics*

- 13 ASAF members suggested including other topics within the scope of the project. Suggestions included:
- (a) undertaking a more comprehensive review of IAS 37, exploring all the topics discussed in the staff paper, if resources allow.
  - (b) specifying the measurement objective more precisely - a more precise measurement objective would provide a clearer basis for decisions on which costs to include, whether and how to reflect risk etc.
  - (c) adding a requirement to disclose information about the assumptions used in measuring the 'best estimate' of a provision. Although IAS 1 *Presentation of Financial Statements* requires disclosure of assumptions made and other sources of estimation uncertainty, this requirement is not always applied rigorously.
  - (d) clarifying whether the measure of a provision should take into account the probability of no outflow being required.
  - (e) reviewing the requirements for reimbursement rights to ensure they are consistent with those in IAS 16 *Property, Plant and Equipment*.
  - (f) aligning the recognition thresholds for contingent assets and contingent liabilities, on the grounds that the existence of a higher threshold for contingent assets than for contingent liabilities contradicts the concept of neutrality.
- 14 One ASAF member cautioned against making the requirements for reimbursement rights less prudent or removing the requirement to adjust provisions for risk.
- 15 Another ASAF member noted that it would not support any change in the recognition criteria for provisions.

**The IASB's project to amend the requirements in regard to onerous contracts**

- 16 In 2017, the IASB started a narrow-scope amendment project to clarify the requirements of IAS 37 in regard to the assessment of whether, in a contract, the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
- 17 The IASB finalised its discussion in December 2018 and issued Exposure Draft *Onerous Contract – Costs of Fulfilling a Contract*. EFRAG finalised its Comment Letter on the Exposure Draft in April 2019. In the Comment Letter EFRAG welcomed the IASB efforts to clarify the requirements of IAS 37 regarding onerous contracts. However, EFRAG also encouraged the IASB to further discuss the potential impact of the proposed amendments on contracts in the scope of the onerous assessment but not previously in the scope of IAS 11 *Construction Contracts*.
- 18 The IASB plans to publish the amendments in **Q2/2020**.

**Question for EFRAG TEG**

- 19 Do EFRAG TEG members agree with the decisions of the IASB in January and the directions of the IASB's project?
- 20 Do EFRAG TEG members have input for the EFRAG Secretariat on the next phase of the EFRAG project?

**Agenda Papers**

- 21 In addition to this project update paper, Agenda Paper 11-02 – *the IASB Staff Research Summary* has been uploaded for background.

## Appendix 1 – Previous projects on the same topic

- 1 IAS 37 was originally issued in 1998. Among others, IAS 37 restricted provisions to items meeting the definition of a liability, as set in the *Framework for the Preparation and Presentation of Financial Statements* issued in 1989, whereas before, entities could make provisions for future costs in absence of a present obligation.
- 2 IAS 37 has been criticised for lack of clarity, for some internal inconsistencies, and for being not aligned with other IFRS Standards, in regard to the recognition criteria for provisions.
- 3 The IASB initiated its first project to improve IAS 37 in 2002. That project mainly aimed to:
  - (a) to align the recognition criteria in IAS 37 with those in IFRS 3 *Business Combinations*; and
  - (b) to eliminate unnecessary differences between IFRS Standards and US GAAP; in particular, the IASB proposed to align the requirements for restructuring costs in IAS 37 with the requirements in US GAAP.
- 4 In 2005, the IASB published an Exposure Draft setting out proposed amendments to IAS 37. The IASB re-exposed the proposals in 2010. The respondents expressed significant opposition to some of the proposals in both the 2005 and 2010 Exposure Drafts. Consequently, in 2010, the IASB suspended the project to amend IAS 37 and finally decided not to continue it.
- 5 During the same period, the IFRS Interpretation Committee (the IFRS IC) has been requested to clarify the recognition criteria of provisions. As a result of its discussions, the IFRS IC published two IFRIC Interpretations:
  - (a) In 2005, IFRIC 6 *Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment*; and
  - (b) In 2013, IFRIC 21 *Levies*.
- 6 Those IFRIC Interpretations, however, have not clarified IAS 37 requirements regarding recognition of provisions and, furthermore, have been criticised as appearing inconsistent with other IAS 37 requirements. IFRIC 21 also results in some of the recurring periodic levies being recognised as expenses at a single point in time.
- 7 Following the 2015 Agenda Consultation and close to the finalisation of its project to revise the *Conceptual Framework*, the IASB started a new research project to review the requirements of IAS 37 and to explore:
  - (a) whether to take on an active project to amend aspects of IAS 37; and
  - (b) if so, what the scope of the active project should be.

### *Revised Conceptual Framework*

- 8 The IASB explained that, when discussing the possible amendments to IAS 37, it will consider the revised guidance of the *Conceptual Framework*. Consequently, it is expected that the IASB may reach different conclusions compared to the previous project ended in 2010.
- 9 The definition of a liability in the old **Conceptual Framework (2010)** was as follows:

*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.*
- 10 However, paragraph 4.26 of the revised **Conceptual Framework (2019)** defines a liability as:

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

- 11 Furthermore, paragraphs 5.7 and 5.8 of the revised *Conceptual Framework* clarify that not all assets and liabilities will be recognised, and that recognition criteria may vary between IFRS Standards. They specify 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.*
- 12 Additionally, the following paragraphs of the revised *Conceptual Framework* discuss 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.*
- 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.*
- 13 The summary of EFRAG’s discussions and position on the amended *Conceptual Framework* and the IASB’s research project on provisions are presented below.

## Appendix 2 - Summary of other EFRAG's discussions and position

### IASB Agenda Consultation 2015

- 1 In January 2016, EFRAG responded to the IASB's Request for Views on *2015 Agenda Consultation* (the RFV). EFRAG classified the proposed project to improve IAS 37 as of low priority.

### Revision of Conceptual Framework

- 2 EFRAG has not specifically commented on the effect of the revised *Conceptual Framework* on provision recognition criteria in IAS 37. However, EFRAG provided the following comments on prudence.

- 3 EFRAG noted that before the 2010 revision of the *Conceptual Framework* prudence was described as:

*[T]he inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated, and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.*

- 4 EFRAG would agree with the pre-2010 *Conceptual Framework* that prudence should not allow for hidden reserves, excessive provisions or deliberate understatements of assets and the deliberate overstatement of liabilities. On the other hand, in case of uncertainty, EFRAG thinks that it may sometimes in standard-setting be useful to require more certainty before recognising income than before recognising expenses.
- 5 As explained in its comment letter in response to the DP, EFRAG considers that prudence represents a degree of caution that generally recognises downside risks and strongly questions whether upside potential inherent in uncertain future events should be recognised. This would mean that when the IASB is setting Standards, it could sometimes set thresholds for recognising losses lower than the thresholds for recognising gains. Currently, many Standards include such different thresholds.

### IASB's Research Project on Provisions

- 6 In March 2019, EFRAG TEG and CFSS members discussed the IASB's project on provisions during a preparatory session for the IASB's ASAF meeting. The summary of the input was as follows:

*The members supported the IASB's initiative. There were mixed views, however, as to whether the definition of a liability would need to be updated in order to address the concerns with IFRIC 21 Levies. Members also suggested that the IASB should clarify the role of detection risk and own credit risk in the measurement of provisions and the impact of economic benefits in assessing whether a contract is onerous.*

- 7 The details of the discussion are provided in Appendix 3 of this paper.

### Appendix 3 – Summary of TEG/CFSS discussion in March 2019

- 1 The EFRAG TEG and CFSS discussed a possible IASB project to make targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- 2 EFRAG TEG discussed the following three main aspects:
  - (a) aligning the definition of liability in IAS 37, and supporting guidance, with the Conceptual Framework; the possible amendments could replace IFRIC 21 – the issue identified by the IASB Staff relates to the recognition of obligation that has arisen from an entity's past actions but is also dependent on the entity's future actions;
  - (b) clarifying which costs to include in the measure of a provision – the issues identified by the IASB Staff include the lack of clarity about which costs should be included as part of the 'expenditure required to settle' an obligation to provide goods or services, and whether an entity should include costs payable to third parties, such as the legal costs associated with settling a lawsuit; and
  - (c) specifying whether the rate at which provisions are discounted should reflect the entity's own credit risk.
- 3 Furthermore, EFRAG TEG discussed whether the following aspects create significant application problems, and whether they should be addressed in the project:
  - (a) adjustment of the measurement of provisions for risks - IAS 37 does not specify the objective of the risk adjustment, and it does not describe the circumstances in which a risk adjustment is required or explain how the adjustment should be measured;
  - (b) onerous contracts – the identified problems include the following issues: (i) whether the phrase 'economic benefits expected to be received under a contract' should be interpreted narrowly i.e. they should include only the economic benefits to which the entity becomes directly entitled under the contract, or more broadly i.e. they should include other expected indirect benefits, for example access to future profitable contracts; (ii) how an entity should measure the cost of fulfilling a contract if the contract will be fulfilled using the entity's existing assets and those assets are carried at an amount other than cost; (iii) lack of the guidance on the circumstances in which contracts should be combined or segmented.
  - (c) Recognition threshold for reimbursement rights – this includes guidance on situations in which an entity's right to reimbursement for a recognised liability is virtually certain, receipt is highly probable and measurement uncertainty is low, but no reimbursement asset can be recognised because receipt is not virtually certain; and
  - (d) Contingent assets in the context of the events after the reporting period – the issue relates to the apparent inconsistency between the requirements for plaintiffs and those for defendants and results in a court ruling or settlement of a court case being treated by a plaintiff as a 'non-adjusting event'.
- 4 The members provided the input that has been considered during the April 2019 ASAF meeting (see the summary of the ASAF meeting comments above in the paper).
- 5 The result of the discussion was that all issues discussed were potential issues to be considered in the IASB's project. Some members had expressed a note of caution that there was no need to change the definition of liabilities while others had referred to the role of detection risk, the role of economic benefits in measuring the onerous contract provision and that it would be helpful to clarify that provisions should not take account of own credit risk.