EUROPEAN COMMISSION
EUROSTAT

Directorate C: Macro-economic statistics
National accounts methodology; Standards and indicators

EPSAS WG 20/01

Luxembourg, 19 June 2020

Consultation prior to the EPSAS Working Group meeting

to be held in autumn 2020

Draft EPSAS Screening Report
IPSAS 19 - Provisions, contingent liabilities and contingent assets

Paper by PwC in cooperation with Eurostat
- written consultation -

This document was commissioned by Eurostat. It analyses the consistency of the named IPSAS standard with the draft EPSAS framework, with a view to informing future EPSAS standard setting. This version was prepared taking into account comments received from the participants of the Cell on Principles related to EPSAS Standards.

In advance of the autumn 2020 Working Group meeting, participants are invited to provide written comments on the analysis provided and on the conclusions reached.

Pilot EPSAS screening report

IPSAS 19 - Provisions, contingent liabilities and contingent assets

March 2020

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Background

Objectives

We refer to the general introduction to the pilot EPSAS screening reports that covers the following elements:

- Key objectives of EPSAS.
- Standard setting process in the public sector.
- Purpose and scope of the screening reports.
- Approach of the screening reports.
- European public good.
- Common elements considered when preparing the reports.

General introduction to IPSAS 19

IPSAS 19 is based on International Accounting Standard (IAS) IAS 37 'Provisions, contingent liabilities and contingent assets', adopted by the International Accounting Standards Board (IASB) in 2001. In developing IPSAS 19, the International Public Sector Accounting Standards Board (IPSASB) applied its 'Process for Reviewing and Modifying IASB Documents' that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

The objective of the IPSAS 19 standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

IPSAS 19 applies to all non-financial liabilities that are not within the scope of other standards. The standard does not apply to some types of provisions, such as provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits. IPSAS 42 "Social benefits" provides specific requirements for such provisions and contingent liabilities.

Elements under the scope of the standard are recognised and disclosed based on its nature (right or obligations) and uncertainties regarding existence and probability of cash inflows or outflows:

- A provision is recognised when: the entity has a present obligation as a result of past events; it is probable (more likely than not) that a transfer of economic benefits will be required to settle the obligation; and a reliable estimate of the amount of the obligation can be made.

- Contingent liabilities are possible obligations that arise from past events and whose existence will be confirmed only on the occurrence or non-occurrence of uncertain future events outside the entity's control, or present obligations that arise from past events but are not recognised because: (a) it is not probable that an outflow of economic benefits will be required to settle the obligation; or (b) the amount cannot be measured reliably. Contingent liabilities are not recognised, but are disclosed, unless the possibility of an outflow is remote.
- Contingent assets are possible assets that arise from past events and whose existence will be confirmed only on the occurrence or non-occurrence of uncertain future events outside the entity's control. Contingent assets are not recognised but are disclosed if the inflow of economic benefits is probable.

Provisions and contingent liabilities may represent a significant and potential cash outflow for governments, which they have to manage alongside other spending obligations and which may reflect an increase in governments' long-term risk profile.

Scope of the report

The present screening report analyses the recognition, measurement, presentation and disclosure requirements of provisions, contingent liabilities and contingent assets. The IPSAS Board issued amendments "Collective and Individual Services" to IPSAS 19 in January 2020.

As a result, paragraphs 6A and AG1-AG20 were added and paragraph 18 was amended. These amendments are effective for annual financial statements covering periods beginning on or after 1 January 2022. This report covers the guidance for collective and individual services.

Reference to EFRAG assessment

No specific individual technical assessment of IAS 37, the IFRS equivalent of IPSAS 19, was carried out by the EFRAG, and therefore no specific individual endorsement report was produced.

The EFRAG however provided on 19 June 2002 a positive assessment of all IAS standards existing at 1 March 2002, including IAS 37, as part of the overall introduction of IAS within the EU.

Reference to EPSAS issue papers[1]

The PwC study of 2014[2] analysed the suitability of the IPSAS standards as a basis for developing EPSAS. This included the analysis of IPSAS 19. Following this analysis, IPSAS 19 was classified among the category 'Standards that could be implemented with minor or no adaptations'. The study indeed revealed no major

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[1] EPSAS Issues papers are available on https://ec.europa.eu/eurostat/web/epsas/key-documents/technical-developments

[2] Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards (Ref. 2013/S 107-182395)

conceptual issues with IPSAS 19, the only comments received related to the practical difficulties upon first-time implementation of the standard.

IPSAS 19 “Provisions, contingent liabilities and contingent assets” might be difficult to apply in practice in some jurisdictions (difficulties regarding the identification and data collection in respect of environmental obligations, identification of contingent liabilities and measurement of long-term obligations).

During the course of developing the technical proposal on EPSAS, Eurostat commissioned a series of twenty technical issues papers (IPs), which analyse in particular key public sector specific accounting issues. The papers were discussed at the EPSAS Working Group meetings during 2016-2018. The papers are all publicly available on Eurostat’s website.

The EPSAS issue paper on the accounting treatment of provisions, contingent liabilities, contingent assets and financial guarantees was discussed by the EPSAS WG on 19-20 November 2018.

Eurostat tentatively concluded the following in respect of the above paper:

- The fundamental question common to the three cases (pensions, provisions, and impairments) is about the basis for defining the (nearly) risk-free rate and how to adjust the risk-free rate for the risk specific to the provision.
- The key issue is the recognition and management of risks, whereas reporting information on provisions and contingent liabilities is an important issue also in the context of EDP statistics, that being a requirement resulting from the Budgetary Frameworks Directive. The consistent implementation of the standards would facilitate the statistical reporting of information on provisions, contingent assets, contingent liabilities and financial guarantees and could support its quality, as it would be drawn directly from the accounts of the reporting entities.
- A common classification of contingent liabilities should be developed on the basis of the probability of occurrence, whereas emphasis should also be placed on making consistent disclosures on contingencies.
- It is worth considering aligning that classification with the ESA classification and the distinction between one-off and standardised guarantees, while remaining within the requirements of financial accounting.

Screening of IPSAS 19 'Provisions, contingent liabilities and contingent assets' against criteria set in the draft EPSAS framework

Introduction

The EPSAS criteria listed in the draft EPSAS framework have been used to perform an assessment of IPSAS 19 'Provisions, contingent liabilities and contingent assets', issued in 2002 by the IPSASB.

In order to develop recommendations, one should first considered whether IPSAS 19 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

This report considers recognition, classification and measurement as well as presentation and disclosure requirements applicable to provisions, contingent liabilities and contingent assets for each of the qualitative characteristics of the draft EPSAS CF.

Further, this paper includes a high-level comparison between the requirements of IPSAS 19 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as IFRS, ESA 2010 and EU Accounting Rules, bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

Finally, the paper assesses whether IPSAS 19 would be conducive to the European public good.

The findings are presented below and the conclusion is included in the next section of this report.

Conformity with Qualitative Characteristics

Relevance

The objective of IPSAS 19 is to define provisions, contingent liabilities and contingent assets, identify the circumstances in which provisions should be recognised, how they should be measured and the disclosures that should be made about them. The standard also requires that certain information be disclosed about contingent liabilities and contingent assets (the items that do not meet asset or liability recognition criteria) in the notes to the financial statements to enable users to understand their nature, timing and amount.

The principal issues in accounting for provisions are:

- The existence of a (legal or constructive) present obligation,
- The assessment of the probability of outflow of resources,
- The best estimate of the amount of expenditure required to settle the present obligation at the reporting date, and
- The presentation and disclosure requirements for contingent assets and liabilities.

The recognition principles in the standard are consistent with the definition of a liability in the draft EPSAS CF. As a reminder, a liability is a **present obligation** of the entity for an **outflow of resources** that results from **past events or transactions**. A present obligation is a legally binding obligation (legal obligation) or non-legally binding obligation, which an entity has little or no realistic alternative to avoid.

- A legal obligation is enforceable in law.
- Non-legally binding obligations differ from legal obligations in that the party to whom the obligation exists cannot take legal (or equivalent) action to enforce settlement.

Under IPSAS 19, provisions are recognised when: (a) an entity has a present obligation (legal or constructive) as a result of a past event; (b) it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

The items should be recognised as non-financial liabilities in financial statements only if they satisfy the definition of a liability and the essential characteristic of a liability is that the entity has a present obligation arising from the past event. The requirements of IPSAS 19 are aligned with definition of an element (a liability) in the draft EPSAS CF.

Further, non-financial liabilities should meet recognition criteria defined in the draft EPSAS CF: (a) an item satisfies the definition of an element; and (b) can be measured in a way that achieves the qualitative characteristics and takes account of constraints on information in GPFSs. The items which fail to meet the definition of an element and the recognition criteria cannot be recognised.

The recognition criteria in IPSAS 19 address the qualitative characteristics by introducing a requirement to have a reliable estimate of the obligation, with a certain level of probability of future outflow of resources. The draft EPSAS CF does not have an explicit probability recognition threshold. The draft EPSAS CF requires that an element can be measured in a way that achieves the qualitative characteristics and takes account of constraints on information in GPFSs.

There might be concerns on whether the probable outflow recognition criterion should be removed, since, among other reasons, increases or decreases in liabilities from one period to the next can give an early indication of a change in management's assessment of the probability. Under the current standard, low probability obligations that could represent significant amounts are not recognised because of the probability threshold in IPSAS 19. Furthermore, a conditional obligation that may result in an outflow of economic benefits is not a present obligation and cannot be recognised. Instead, appropriate disclosures about contingent liabilities are provided in the notes, unless the probability of occurrence of the uncertainty is remote.

The information about provisions as required by IPSAS 19 is relevant in assessing the level of non-financial liabilities and the timing of cash outflows. It has an important predictive value because it shows the level of cash outflows required to settle the obligations, arising from both legal and constructive obligations.

For example, IPSAS 19 states that an entity that (a) has a detailed formal plan for restructuring and (b) has raised a valid expectation in those affected that it will carry out the restructuring, has a constructive obligation. Therefore, it recognises a provision for the direct expenditures arising from the restructuring.

A decision by the management of an entity to undertake a restructuring does not create a present obligation to others for costs expected to be incurred during the restructuring. Accordingly, a decision by the management of an entity to undertake a restructuring is not the requisite past event for the recognition of a non-financial liability. The same principle applies to other provisions arising from constructive obligations (the internal environmental policies, warranties not formalised through contractual arrangements etc.). The objective evidence of the constructive obligation (for example as a result of restructurings, environmental policies or warranties not formalised through contractual arrangements, etc.) required by IPSAS 19 is difficult to assess when it comes to the existence of informal practices and stated internal policies. Description of the management judgment is necessary in such cases, for the information to be relevant and complete.

The robustness of the assumptions used in the determination of the best estimate of the cash outflow (in many cases measurement of provisions depends on internal data and assumptions) could affect the relevance of the information.

Faithful representation / Reliability

The notion of faithful representation and reliability in the draft EPSAS CF is linked to the qualitative characteristics of completeness, prudence, neutrality, verifiability and substance over form. These are separately discussed below.

Similarly, as stated above, under QC 'Relevance', the robustness of the assumptions used in the measurement of provisions could also affect the reliability of the information.

For example, proponents of the fair value measurement believe that fair value is the most relevant and faithful representation of the underlying economics of a transaction. IPSAS 19, on the other hand, requires provisions to be measured at the best estimate of the expenditure required to settle the present obligation or to transfer it to a third party on the balance sheet date. The IPSAS 19 requirement can be interpreted as not conflicting with the notion of fair value, however the questions about the conceptual merits of the 'best estimate' as compared to the 'fair value' remain unresolved. For the sake of clarity, the best estimate of the future cash flows does not take into account all the possible settlement scenarios weighted by their respective probabilities of occurrence.

For example, in many cases there would be no directly observable market price for the obligations, for example in the case of a disputed lawsuit or a warranty included in the price of a product. In such cases an entity would need to use a surrogate for measuring the obligation. The amount an entity would expect to pay to settle the obligation would reflect the likelihood, amount and timing of the expected cash flows attaching to the conditional obligation. Thus, the most appropriate way to measure such an obligation is to use an expected cash flow approach.

Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is expected value. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability.

For many non-financial liabilities (for example those arising from legal obligations) the law of large numbers does not apply and therefore expected values may be less appropriate. The 'dual approach' to the measurement required under IPSAS 19 ("according to the circumstances") satisfies the objective of reflecting the 'best estimate of the outflow of the economic benefits'.

It is however important to provide examples of the circumstances where the use of the individual most likely outcome would be the best estimate of the liability as opposed to the expected value approach.

IPSAS 19 para 48 states: "*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 mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount (…)*".

There is no additional guidance on determining how this estimate should be measured and to what extent the expected value method should be taken as a reference, so different approaches could be adopted by the preparers.

Further, IPSAS 19 provides no guidance regarding the circumstances in which a risk adjustment would be required and the way it should be measured when calculating the best estimate.

In general, application of the recognition and measurement requirements for provisions results in a faithful representation of the non-financial obligations in the statement of financial position, consistent with the definition of a liability and the recognition criteria defined in the draft EPSAS CF. There is a debate about the need to have a "probable" recognition threshold. Further, discussions are going on about whether guidance could be developed with respect to measurement methods applicable for various types of outcomes, including application (or not) of a risk adjustment.

When the probability of cash outflows is remote, no information (i.e. even no disclosure) should be given. Under these circumstances, such information might confuse the readers of financial statements and be misleading. This would not meet the relevance QC of financial statements.

Completeness

The standard applies to all the non-financial liabilities not addressed in other accounting standards. It does not define the nature of the obligating events that could create a present obligation for an entity resulting in an outflow of economic resources. Additional requirements to provide information about possible obligations and present obligations with low probability of cash outflows achieves the objective of completeness of the information provided to the users of the financial statements.

Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by the standard in a way that shows the link between the provision and the contingent liability. This requirement contributes to the transparent and complete reflection of management's assessment of the future cash outflows.

IPSAS 19 has been amended to include specific guidance for the obligations and expenditures arising from the collective and individual services provided by the public sector entities. The amendment does not modify the principles of IPSAS 19.

Collective services are considered to be ongoing activities of the public sector entity that delivers the services. In accordance with IPSAS 19, “Provisions, contingent liabilities and contingent assets”, “no provision is recognised for costs that need to be incurred to continue an entity’s ongoing activities in the future” (IPSAS 19 para 26). Consequently, no provision is recognised for the intention to deliver collective services. As with collective services, no provision is recognised for the intention to deliver individual services prior to individuals and/ or households accessing the services.

The expected future sacrifice of resources (government expenditure incurred to provide individual and collective services to address the needs of the society) does not give rise to a present obligation and therefore does not meet the liability recognition criteria in the draft EPSAS CF.

Therefore, the accounting for universally accessible services and collective services as services are delivered does not negatively affect the completeness of the financial information. The services in the scope of the amendment do not give rise to obligating events and therefore liabilities or expenses do not arise prior to the delivery of those services to beneficiaries.

The standard requires disclosures for each class of provisions. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the disclosure requirements. Thus, it may be appropriate to treat as a single class of provision amounts relating to one type of obligation, but it would not be appropriate, for example, to treat as a single class amounts relating to environmental restoration costs and amounts that are subject to legal proceedings.

Although the aggregation principle is clear, no further guidance is provided about the appropriate levels of aggregation for the disclosure purposes. Therefore, prudent and careful application of aggregation principles (identification of classes of provisions with similar nature) is essential for providing relevant and complete information to the users. Aggregating provisions and contingencies with different nature and functions could lead to significant compensations and reduce the quality of the financial statements (fair representation).

The standard requires a reconciliation of the opening to closing balance of the period showing additions and usage of provisions, acquisitions through public sector acquisitions, reversals, exchange rate differences and other movements for each class of provisions. Reconciliation of the opening to closing balances provides users with a complete overview of changes in provisions at each reporting date.

Prudence

Contingent assets and liabilities are defined in IPSAS as **possible** assets and obligations arising from past events whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. A contingent liability may also be a present obligation

that arises from a past event, but which is not recognised because an outflow of resources is not probable, or the amount of the obligation cannot be measured with sufficient reliability. Information provided about contingent assets meets the QC of prudence. Indeed, contingent assets are disclosed where an inflow of economic benefits or service potential is probable (IPSAS 19 para 42) and not recognised in financial statements since this may result in the recognition of revenue that may never be realised (IPSAS 19 para 41). An example of a contingent asset is a claim that an entity is pursuing through legal processes, where the outcome is uncertain yet likely favourable to the entity.

Contingent assets are regularly reviewed by management to ensure that developments are appropriately reflected in the financial statements. If an inflow of economic benefits or service potential has become probable, an entity discloses the contingent asset. If it has become virtually certain that an inflow of economic benefits or service potential will arise and the asset's value can be measured reliably, the asset and the related revenue are recognised in the financial statements of the period in which the change occurs (IPSAS 19 para 43).

When the realisation of revenue is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate (IPSAS 19 para 41). When the revenue is virtually certain, conditions for recognition of an asset in the draft EPSAS CF are met. An entity has a resource with service potential or the ability to generate economic benefits, presently controlled by the entity as a result of past events or transactions (draft EPSAS CF). When the inflow of economic benefits is virtually certain, the asset can be measured in a way that achieves the qualitative characteristics and takes account of constraints on information in GPFSs.

For example, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset in the statement of financial position (IPSAS 19 para 63), consistent with the application principle 'Offsetting/aggregation" in the draft EPSAS CF: Assets and liabilities, and revenue and expenses shall not be offset unless so required or permitted by an EPSAS'.

Executory contracts are excluded from the scope of IPSAS 19. However, public sector entities may enter into contracts for the exchange of assets or services under which the unavoidable costs of meeting the obligations exceed the economic benefits or service potential to be received. A provision should be recognised in respect of such contracts which are onerous. This approach achieves prudent accounting for the loss-making contracts by recognising the expected loss in the period when the contract becomes loss-making. This approach contributes to the overall objective of accountability in the public sector since the loss-making contracts should be identified, monitored and reported by the public sector entities' management.

Neutrality

Information is neutral if it is free from bias. GPFSs are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

IPSAS 19 requires strict criteria to be met before a provision can be recognised. If the recognition criteria are not met, no liability is presented in the financial statements. Such strict rules prevent the abusive recognition of unjustified provisions and ensure the neutrality of information included in the financial statements.

IPSAS 19 requires different thresholds for the assets to be recognised (i.e. virtually certain) and for provisions (i.e. more likely than not). This asymmetry is viewed by some users as a strength of the standard, since to be useful, amounts recognised as assets need to have a high degree of certainty. It prevents that the uncertain future inflows and outflows are recognised based on subjective assertions about their financial outcome.

Sometimes, however, this asymmetrical treatment leads to different timing of recognition of liabilities and assets when there is a provision and a reimbursement right for the same event (insurance reimbursements, long-term warranties, etc.).

The principles included in IPSAS 19 (the equivalent IFRS standard IAS 37) have been tested for many years in the private sector. Users perceived no negative impact of IAS 37 that could be linked to the neutrality QC. The requirements to apply accounting policies consistently year on year and to disclose such policies in the notes to the accounts reinforce the neutrality QC.

Verifiability

Verifiability is the quality of information that helps assure users that GPFSs is based on supporting evidence in a way that it faithfully represents the substance of economic and other phenomena that it purports to represent.

Appropriate disclosures about provisions, contingent liabilities and contingent assets enable users to verify the information provided. Among others, outputs of the calculations as well as uncertainties about the amount or timing of the future outflows are disclosed.

However, best estimates are often judgmental and are determined by management based on the best information available. This inevitably involves a certain degree of subjectivity. The methods and techniques of estimation used by the entities (although explained in the disclosures) may not be entirely clear or verifiable. The use of estimates is however inherent in the preparation of financial statements and cannot be avoided.

Substance over form

'Substance over form' QC is achieved when the underlying transactions, other events, activities or circumstances are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form.

No specific issue in IPSAS 19 has been identified which could question the 'substance over form' QC.

Understandability

'Understandability' QC is achieved when information is presented in a manner that facilitates expert and non-expert users to comprehend its meaning.

IPSAS 19 provides useful information for the users to understand the amounts, uncertainties (regarding timing and amounts) and the description of the nature of the provisions that are recognised and contingent liabilities and assets that are disclosed.

The accounting treatment under IPSAS 19 makes a proper distinction between the items that meet the criteria for recognition as assets and liabilities and other uncertainties that are relevant to an understanding of the possible obligations and risks of public sector entities

The potential difficulties encountered when applying discounting under IPSAS 19 can be summarised as follows:

- technical complexity and conceptual approach to determining the appropriate discount rate;
- volatility due to changes in discount rates, understandability of impact and usefulness for the decision making.

The primary objective of discounting is to take into account the time value of money in measuring certain assets and liabilities. The longer the maturity or the expected settlement date of a liability, the higher the impact of discounting on the net present value of that liability. If the basic concept around discounting may be understood quite easily, application of discounting proves to be a relatively complex area in practice. In addition, judgment is often required in applying the principle-based guidance included in the IPSAS 19 when selecting the appropriate discount rate for long-term provisions.

The IPSASB discussed a need for improved guidance in the area of discount rates but decided not to add discount rates to its 2019-2023 Work Plan[3]. Instead, the IPSASB plans to develop an approach that will facilitate groups including national standard setters undertaking initial research and scoping on important public sector accounting issues in advance of decisions on whether to proceed with IPSASB projects.

[3] Strategy and workplan 2019-2023 https://www.ifac.org/system/files/publications/files/IPSASB-Strategy-and-Work-Plan-2019-2023.pdf

Even though no significant issues were noted in the private sector, the term “contingent liability” could be misleading for users of financial statements. The term includes: (a) items for which it is uncertain whether an obligation exists; (b) items for which an obligation exists, but it is not probable that an outflow will occur; and (c) items that cannot be measured reliably. Different terminology could be suggested for various types of resources and claims not recognised in the financial statements, in order to improve understandability. The same would be applicable to the term “contingent assets”.

Comparability

A key objective of EPSAS is to achieve the necessary level of financial transparency and comparability of financial reporting, between and within EU Member States.

There are no policy choices given in IPSAS 19. However, there are certain areas in which further guidance could be developed, so the information could be more comparable.

The discount rate for provisions should reflect the time value of money and the risks specific to the liability. In practice, the risks inherent to the liability are incorporated in the estimate of the future cash flows and the discount rate used reflects the time value of money. There is thus no double counting. However, discounting approaches set by IPSAS 19 only describe principles for the calculation, without providing detailed guidance, which results in lack of clarity and variety of interpretations. Specifically, it is not clear whether the discount rate should include the entity’s own credit risk or a (lower) risk-free rate should be used for discounting the provision.

In addition, the impact of negative interest rates on the risk-free rate (as evidenced by government bonds of different maturities issued within the EU) should be addressed. For example, the question arises about the negative time value of money: whether a third party would require a payment greater than the expected future cost to compensate for the loss in value of the payment as a result of negative rates.

There is no guidance regarding the term “expenditure”, of which the entity needs to make its best estimate. There is diversity in practice with respect the costs that should be included when recognising and measuring the provision.

For example, it is unclear how entities should measure expenditure required to settle obligations to provide goods (such as inventories) or services (such as decommissioning or environmental rehabilitation). It is not clear whether only incremental costs of manufacturing an asset or providing goods required to fulfil a liability should be included, or whether the costs should also include other directly related costs.

IAS 37 has been silent on what it means by ‘expenditure’, leaving scope for diversity in practice. IAS 37 is also unclear about whether the expenditure required to settle a provision includes costs payable to third parties, such as legal costs expected to be incurred in negotiating the settlement of a legal claim.

Regarding onerous contracts, further guidance should be developed in order to determine which costs should be included whether the 'cost of fulfilling' a contract (i.e. incremental costs, allocation of other costs of contracts activities, and other costs). There is no guidance on whether the "economic benefits or service potential expected to be received" should be interpreted narrowly or broadly, and whether, if so, the entity should combine or segment contracts for the purpose of assessing them being onerous.

When a principle-based approach is applied, the calculation always leaves space to judgment by preparers, unless a precise centralised guidance is available, or the calculation is performed at a centralised level.

Similar rules exist in IFRS for private companies and do not raise major concerns of preparers. These companies develop their own guidance and apply their best judgment in respect of the treatment of provisions.

Alignment with other frameworks

ESA 2010

In macroeconomic statistics, a liability is not recognised until a claim by the counterparty exists. Maintaining symmetry in the macroeconomic statistical system is a fundamental principle. Therefore, ESA 2010 guidance is that probable exposures that may exist as a result of contingencies and one-off guarantees should be disclosed in memorandum items, until such time as these are called.

Under ESA 2010, a financial claim is the right of a creditor to receive a payment or series of payments from a debtor. Financial claims are financial assets that have corresponding liabilities (ESA 2010 5.05). Liabilities are established when a debtor is obliged to provide a payment or a series of payments to a creditor (ESA 2010 5.06).

Under ESA 2010, a provision is not recognised until a claim by the counterparty exists. The timing of recognition of provisions is therefore not the same as under IPSAS 19, because the existence of the present obligation does not always give rise to a claim by the counterparty in the same accounting period.

IPSAS provides for the recording of provisions defined to be liabilities of uncertain timing or amount, which also include obligations for which no specific counterparty is identified, for example provisions for restructuring and environmental restoration. On the contrary, ESA 2010 rules do not record provisions because the national accounts system is necessarily symmetric, and the values of assets and related liabilities must match.

For example, recognition of a provision for restructuring under IPSAS 19 requires recognition of a related expense, because there is no compensating increase in asset value. Recognition of a provision for eventual site restoration during construction of an asset is, under IPSAS, capitalised, adding to the overall investment in the asset. Statistical rules do not recognise either these items until a

point in the process where another party can be identified as receiving value (when the claim by the counterparty exists).

Government liabilities should as a general rule be recorded in national accounts at their market value (ESA 2010 1.94). On the other hand, provisions under IPSAS are recognised for the best estimate of the expenditure required to settle the present obligation at the reporting date.

Contingent liabilities and contingent assets under ESA 2010

Contingent assets and contingent liabilities are agreements whereby one party is obliged to provide a payment or series of payments to another unit only where certain specific conditions prevail. As they do not give rise to unconditional obligations, contingent assets and contingent liabilities are not considered as financial assets and liabilities (ESA 2010 5.08).

IPSAS rules do not provide any detailed guidance on the presentation of provisions, contingent liabilities and contingent assets. Information to be disclosed in the notes in relation to provisions and contingent liabilities should be given by class, but no specific guidance is provided on the categories that are common for the public sector entities. Further guidelines on specific types of transactions that should be recognised as provisions, contingent assets and liabilities would contribute to the comparability of the EPSAS financial statements.

ESA 2010 do not prescribe rules for provisions. The consistent implementation of the standard will facilitate the statistical reporting of information on provisions, contingent assets and contingent liabilities, and guarantee its quality, as the required information will be available in the accounts of the reporting entities.

IFRS[4]

IPSAS 19, “Provisions, contingent liabilities and contingent assets” is drawn primarily from IAS 37, “Provisions, contingent liabilities and contingent assets”.

The main differences between IPSAS 19 and IAS 37 are as follows:

• IPSAS 19 includes commentary to clarify the scope of IPSAS 19. In particular, it does not apply to provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of the goods and services provided directly in return from recipients of those benefits. However, if the entity elects to recognise provisions for social benefits, IPSAS 19 requires certain disclosures in this respect.

• In the case of onerous contracts, IPSAS 19 clarifies that the present obligation net of recoveries is recognised as a provision.

• The scope paragraph in IPSAS 19 makes it clear that while provisions, contingent liabilities and contingent assets arising from employee benefits are excluded from

[4] Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf

the scope of the standard, the standard, however, applies to provisions, contingent liabilities and contingent assets arising from termination benefits that result from a restructuring dealt with in the standard.

• IPSAS 19 uses different terminology, in certain instances, from IAS 37. The most significant examples are the use of the terms entity, revenue, statement of financial performance, and statement of financial position in IPSAS 19.

• IPSAS 19 contains the definitions of technical terms used in IAS 37 and an additional definition for “executory contracts.” • The Appendix C examples have been amended to be more reflective of the public sector.

• IPSAS 19 contains an additional appendix (Appendix E) which illustrates the journal entries for recognition of the change in the value of a provision over time, due to the impact of the discount factor.

EU accounting rules

EAR 10 “Provisions, contingent liabilities and contingent assets” is based on IPSAS 19 as regards the scope, recognition and measurement of provisions, contingent liabilities and contingent assets. There are no significant differences between EAR 10 and IPSAS 19.

European Public Good

Assessing whether IPSAS 19 is conducive to the European public good

The assessment of whether IPSAS 19 would be conducive to the European public good addresses the following items:

a) Whether the standard will improve financial reporting;
b) The costs and benefits associated with the standard; and
c) Whether the standard could have an adverse effect to the European economy, including financial stability and economic growth.

These assessments will allow the EU authorities to draw a conclusion as to whether the standard is likely to be conducive to the European public good.

The analysis revealed no reasons why IPSAS 19 would not be conducive to the European public good:

- Recognition, classification, measurement, presentation and disclosure requirements of IPSAS 19 will provide useful information to the users of the GPFSs and will improve the overall quality of financial reporting in the public sector. The main criterion in assessing the proposals is whether the accounting information provided about an entity’s non-financial liabilities and the uncertainty related to the future outflow of economic benefits, that will be required to settle them, will be improved when compared to the information provided currently under the local accounting frameworks of the EU member states. Based on the assessment, the requirements of IPSAS 19 satisfy this criterion.
- Implementation of the standard should result in a moderate one-off cost and should be relatively cost-neutral on an ongoing basis for preparers. It should require bigger efforts for public sector entities that move from a cash-based accounting environment given the data required to report the liabilities of uncertain timing or amount in the statement of financial position in accordance with accrual-based principles. Entities will need to put in place adequate administrative processes, including a reliable tracking system of the events that trigger recognition of provisions and reporting of contingencies, and processes that enable to generate reliable information to measure such items. These practical challenges do not overweight the conceptual merits of the standard.
- Considering its conceptual merits, the standard will bring improved financial reporting when compared to heterogeneous reporting requirements currently applied in the EU. As such, its endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship. The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

Conclusion

Assessing IPSAS 19 against the criteria formulated in the draft EPSAS framework

The analysis has not revealed major conceptual issues with IPSAS 19 'Provisions, contingent liabilities and contingent assets' and has not identified any inconsistency between IPSAS 19 and the draft EPSAS framework.

Following the screening analysis summarised in the present report, the future standard setter could consider following conclusions. The information resulting from the application of IPSAS 19:

- would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information needed for making economic decisions and achieving the necessary level of financial transparency and comparability of financial reporting in the European Union;
- would not be contrary to the true and fair view principle; and
- would be conducive to European public good.

However, in order to achieve consistent application of the new standard within the EU context and therefore better address the comparability objective of EPSAS financial statements, additional guidance and improvements in certain areas might be desirable.

- *Selection of an appropriate discount rate.* The approach to measure provisions, contingent assets and contingent liabilities may differ amongst entities. The value of provisions reported in the accounts may be significantly affected by the discount rate used. On a legal claim provision, for example, the value may be discounted over just a few years whereas environmental provisions may need to be discounted over a very long period of time. Providing additional guidance with regard to the discount rate relevant for EU central governments, including situations in which interest rates are negative, may lead to better consistency in terms of figures reported by central governments.

- *Consistent classification.* The need for a consistent classification and presentation of provisions, contingent liabilities and contingent assets. Both internationally recognised accounting frameworks (IPSAS and IFRS) require provisions to be presented on a separate line item on the statement of financial position. Further subclassification is generally given in the notes by class in a way that is appropriate to the circumstances of the reporting public sector entity.

Various sub-classifications are possible, for example based on those types of provisions that are most frequently encountered in practice.

- *Additional guidance for assessment of contingent assets and liabilities*. Providing additional guidance to Member States when it comes to specific notions not specifically addressed by international standards may lead to better harmonisation and transparency for the readers of the accounts. For example, the lack of guidance on remote contingent liabilities may limit transparency and increase the potential for inconsistency in reporting. Under IPSAS and IFRS, there is no specific indicator as to when a contingent liability should be classified as remote, which may lead to a diversity of practices in classification of contingent liabilities.

- *Judgment and comparability.* The use of judgment and estimates is inherent in the preparation of financial statements and may to some extent affect the comparability of financial statements (which is compensated by the explanations given in the notes). This is particularly true in relation to the accounting of provisions and the disclosure of contingent assets and liabilities.

The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

The future standard setter could consider the conclusions of this assessment and likely net benefit of using the requirements of IPSAS 19 as a starting point in implementing the equivalent EPSAS, considering the need for additional guidance in certain areas and resolution of the matters identified in the present EPSAS screening report.